

RSM! McGladrey



California Department of Insurance

State Compensation Insurance Fund Operational Review Report

October 2007

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San Francisco, California
October 31, 2007

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an Operational Review was made of the

STATE COMPENSATION INSURANCE FUND

at its home office located at 1275 Market Street, San Francisco, California 94103.

Introduction

RSM McGladrey, Inc. (RSM McGladrey) was appointed by the California Insurance Commissioner to conduct an operational review of the State Compensation Insurance Fund (SCIF) pursuant to California Insurance Code Section 733(g). This review was initiated by the California Department of Insurance (CDI) in response to the CDI's preliminary financial examination findings related to corporate governance and other management issues, as well as issues publicly disclosed by SCIF earlier this year including SCIF's Group Association Programs, internal investigations and management changes.

The SCIF Board of Directors initiated an independent investigation of SCIF last year to review the Group Association Programs and related internal controls among other SCIF internal operations. This investigation continues and a referral was made to the California Highway Patrol (CHP), which has jurisdiction over state agencies regarding certain activities. The CHP, CDI, and the San Francisco District Attorney's Office formed a task force (joint task force) to coordinate efforts in the investigation of potential criminal misconduct by former employees. Two key SCIF executives, President Jim Tudor and Executive Vice President Renee Koren, were removed from their positions on March 20, 2007.

The internal controls and corporate governance subject to this operational review conducted by RSM McGladrey are representative of the controls in place at SCIF as of September 11, 2007. While certain recommendations were made based on noted deficiencies, SCIF management has indicated it is taking steps that should improve the corporate governance and internal controls environment. Where applicable, we have indicated the status of these efforts. While the control environment at SCIF is in a state of change, the actual operating effectiveness of key controls recently adopted has not yet been tested.

Scope and Approach

Our operational review of SCIF consisted of several procedures including interviewing the executive management team and key personnel involved in management of day-to-day operations of the programs under review, conducting process walk-throughs of critical systems and functions such as claims, underwriting, invoice processing, and vendor contract procedures; reviewing and testing certain internal controls for each respective scope area, and performing limited testing of underwriting and claims processing at the district offices.

Specifically, our review focused on the following areas:

- **Governance and Management Practices**, includes a review of the entity's risk management activities which encompasses the governance structure over the management positions as well as an assessment of the internal audit function and human resources function.
- **Group Association Programs**, includes a general review of the group association program components, participation in the group interviews conducted by SCIF investigators, and independently analyzing data provided by associations.
- **Information Technology (IT)**, includes an assessment of general IT controls of the SCIF IT environment.
- **District Offices and Claims Processing Centers**, includes an initial operational review of four district offices and three claims processing centers.
- **Business Services**, includes a limited review of the business applications unit and purchasing/ transportation/ supply unit, which focuses on the IT vendor process and fleet car management.

SCIF History

SCIF is California's leading writer of workers' compensation insurance, and serves as California's insurer of last resort for workers' compensation insurance. SCIF's creation by the California Legislature in 1914 occurred concurrently with the enactment of the first compulsory workers' compensation laws in California, to assure California employers of the availability of workers' compensation coverage at the lowest possible cost. The law provides that SCIF must compete fairly with other insurers, must be no more and no less than self-supporting. SCIF's organization and powers are defined by the California Insurance Code.

The following summary includes a brief discussion of the significant findings of this review. Following the summary is a comprehensive discussion of the specific findings and recommendations.

Significant Findings

Governance and Management Practices

It is necessary for an entity the size and complexity of SCIF to have a strong management team in place to establish and monitor an effective corporate governance structure. SCIF should consider the following options as it realigns its management and governance structure.

Chief Officer Positions

SCIF lacks key management positions that are present at comparable insurance companies. In order for SCIF to have an effective management structure, new exempt management positions should be established. The governance structure at SCIF needs at least five additional exempt positions to promote sound operational practices. These positions are Chief Financial Officer (CFO), Chief Information Officer, Chief Investment Officer, Chief Operating Officer and General Counsel. Legislation should be enacted to allow SCIF to create these five exempt positions in order for SCIF to compete with other firms of its size and to attract the most qualified individuals. It is important that duties for these executives be properly outlined. Additional exempt positions may be needed as SCIF reorganizes other functions and enhances controls within the organization.

SCIF has been utilizing two consultants to fulfill the duties of the CFO position. These consultants will not be renewing their contracts with SCIF at year end. SCIF does not have a plan for the assumption of these duties after year end. SCIF should retain a consultant to assume the CFO duties by year-end. The earliest legislation could be enacted to provide for a permanent CFO position would be in 2008.

Board of Directors

The SCIF Board has only five members, which makes it difficult to form committees, as the same members would sit on all committees due to the Board's limited size. There are minimal qualification provisions for Board members in the California Insurance Code. This creates difficulties in obtaining a diverse Board. The Board's compensation structure is well below other comparable boards for an entity of this size and complexity. Board member training is conducted informally at the discretion of the Board Chair. SCIF employees typically design training curriculum for Board members at the Board's request.

Significant changes should be made to the Board. The size of the Board should be expanded. It is noted that these Board modifications require amendment to the California Insurance Code through new legislation. Board terms and qualifications should also be reviewed and revised. The Board should ensure that conflicts of interest do not limit members' capacity to function effectively. It is important that the majority of Board members have diverse qualifications with base line insurance knowledge. SCIF should consider having an investment expert represented on the Board as well as a legal expert. The appointment process should assure that only highly qualified individuals, without conflicts, are considered for appointment to the SCIF Board. Once the expanded Board is filled, the Board should be divided into committees to conduct business more effectively. Earlier this year SCIF formed an audit committee. Budget, governance and compensation committees should also be formed to address current issues and provide effective oversight. In order to attract and retain qualified Board members, SCIF should review the Board members' current compensation structure to bring it in line with comparable organizations.

SCIF is a unique organization that operates in a specialized market. It is important that SCIF develop a training curriculum for Board members. This training program should be approved by the Board Chair. All Board members should be required to complete this training. Board training should include corporate governance and ethics. Additionally, Board members should, at least annually, participate in educational sessions related to trends in the workers' compensation market.

Certain Board budget directives were not followed by SCIF executives. SCIF has not developed standard reporting parameters for consistent communication and reporting to the Board. The Board should develop a mechanism to ensure that pertinent financial information, including budget information and other related matters of importance, is presented and approved by the Board on a regular basis. Set parameters for Board reporting should be approved and followed by SCIF executives. The Board should appoint one executive to be the responsible party for this information. It is recommended that the President or General Counsel assume this role. Additionally, the Board should ensure that information is received from an array of executive officers so that the entire management team's expertise is fully utilized.

Governance Framework

SCIF has not adopted a formal governance framework. SCIF established a SOX Committee in March 2005 to review internal control processes of key accounts related to executive certification of the financial statements. SCIF should adopt a corporate governance framework that addresses the development of effective internal controls. The NAIC Model Audit Rule or the Sarbanes Oxley Act of 2002 may serve as models for SCIF regarding monitoring and control over financial reporting. SCIF should consider widely accepted objective standards such as the "Committee of Sponsoring Organizations" (COSO) and "Control Objectives for Information and related Technology" (COBIT).

General Management Practices

SCIF executives formed a committee to address risk management issues. However, it was unclear if the SOX Committee would disband and be merged with this new committee. It is recommended that SCIF retain both committees. The Enterprise Risk Assessment Committee (Risk Committee) should review and monitor potential prospective risks as well as current risk indicators, while the SOX Committee should continue to focus on internal control enhancements over financial reporting and disclosure.

Certain members of the Executive Committee were not fully informed on the use of key consultants. The Board and the President should ensure that executives and staff working with consultants understand the scope of the consultant's engagement. Executives that have primary oversight responsibility for consultant use should regularly communicate with the consultant and apprise the President regularly on the status.

SCIF does not engage in formal succession planning. Strategic succession planning is critical for SCIF as many of its experienced staff are nearing retirement. Human Resources (HR) should work with the executive management team to develop a formal succession plan.

An improved communication process should be implemented throughout the organization. Management should assume an active role in communicating corporate changes, both formally and informally, with its employees. A formal communication strategy should be developed and approved by the Board.

There is no established procedure to ensure that company issued equipment, SCIF property or records are returned upon an employee's termination or resignation. HR does not regularly communicate directly with the IT Department to provide notification of terminated employees. Program managers and others notify IT through different means without following specific procedures. The same practice is followed for employees

that are promoted or transferred into different programs. Due to the lack of controls in place within IT, employees may be granted multiple accesses to various software tools or information outside of their current employment and terminated employees may still have access to SCIF systems. HR should develop written procedures to safeguard SCIF's assets and proprietary information when an employee is terminated, resigns or transfers to another position within the organization. It should be the Enterprise Security Department's role to ensure that employee access to systems has been appropriately terminated or revised timely. SCIF stated it is enhancing procedures in this area.

District office management currently performs the typical HR responsibilities. HR confirmed that its involvement with the district offices is limited. The rationale provided for this process is that the district offices are decentralized, and the lack of HR involvement was part of the corporate plan. HR should oversee all related matters that fall under its supervision not just those that are at the SCIF home office. HR should actively visit district offices and participate in oversight. The SCIF Employee Handbook should be reinstituted as a tool for employees.

Internal Audit

Internal audit develops its risk planning model primarily from internal assessment surveys and NAIC branded risk classifications. There was no reference to market conditions reflected in the risk planning model. Internal Audit should continue to refine its risk planning model. Consideration should be given to all regulatory issues and industry market conditions that may not be reflected in the responses collected from management. Internal audit should conduct an independent assessment of these areas and factor this into the risk planning model. The Board should also ensure that Internal Audit resources are adequate to address the risks facing SCIF.

Based upon discussions held with Internal Audit personnel, the IT auditors do not have a strong background in IT. Although a newly formed unit, Special Projects/External Unit, in Internal Audit allows for the contracting of IT specialists when needed, SCIF should require additional training for existing IT auditors in the area of Information Systems and COBIT standards.

Group Association Programs

SCIF offers policyholders the option to join an association (i.e., group) in a variety of industries throughout California in order to obtain insurance through a group association plan, as opposed to an individual policy. All group policies receive a six percent discount. As this group discount can be combined with other SCIF discounts, employers save on their premiums by being members of an association.

Pursuant to their contracts, group associations are also supposed to provide safety services. Group associations are paid an administrative fee for their services. Group administrative fees paid since 1997 amount to approximately \$524 million. The administrative fee is calculated based on a percentage of the estimated annual premium as calculated by SCIF. In many instances, little to no safety services, or any other services, were provided to the members of the associations being paid these administrative fees. The structure of the administrative fee calculation motivated the associations to increase their membership base (more premiums equate to more fees), not to increase the safety services provided to members. It is because of this that the administrative fee may be likened to brokerage fees.

From 1997 to June 2007, SCIF paid close to \$140 million in group administrative fees to Western Insurance Administrators. This association was controlled by an individual who also served as a Board member for SCIF from 2003 to 2006. For the same period, SCIF paid approximately \$125 million to associations related to Golden State Builders Exchange. Similarly, this association was controlled by an individual who served as a SCIF Board member from 2004 to 2006. Frank DelRe, President of Western Insurance Administrators, and Kent Dagg, Executive Director of Shasta Builders' Exchange, both resigned their positions on SCIF's Board of Directors in 2006. The Board minutes indicated that there were no conflicts of interest. The CDI is referring these findings to the joint task force. Effective October 1, 2007 the groups administered by Western Insurance Administrators were not renewed by SCIF. However, SCIF has indicated it will offer to renew policies directly with the insureds. It is recommended that the Board take action to ensure that its members do not personally benefit, either directly or indirectly, as a result of decisions made by the Board. Per the Board's publicly issued status report on August 23, 2007, SCIF indicated it was developing a code of ethics policy for board members, officers and employees. This policy will include, among other provisions, articles related to financial conflicts of interest and procedures for investigations of directors and officers concerning ethics complaints. SCIF also indicated that it is in the process of preparing an Employee Incompatibility Activities policy. The Board is scheduled to review and adopt this policy in the later part of 2007.

Based upon interviews with group administrators, some group associations were paid millions of dollars for merely sending members quarterly newsletters and providing little or no other safety services. In many instances, SCIF employees actually wrote most of the content for the newsletters. SCIF group contracts were written poorly, which allowed associations to be in compliance with their contract while providing minimal services. SCIF should develop contracts that require specific services to be performed commensurate with the administrative fees paid. The administrative fee should not be similar to a brokerage commission. In 2007, SCIF developed contracts which require specific administrative and/or safety services be performed.

The group contract provision that permitted SCIF to review group association expenses was not exercised. SCIF should enforce the contract provision that allows for a review of group expenditures. Additionally, a new contract should be developed for the groups that allow SCIF to periodically audit the group associations for contract compliance.

No internal audit reviews were completed for the group association program despite the fact that it represented a significant portion of SCIF's business. The 2005 scheduled internal audit was never completed as SCIF allocated Internal Audit resources to other reviews that SCIF management stated were higher priorities. SCIF should regularly include a review of the group programs in the Internal Audit Plan. A review should be completed at least once every three years, prioritized according to the program's significance.

There was one group association that had both a multi-year and one year contract signed. The group claimed that the multi-year contract was in-force. SCIF should have the Legal Department review and retain copies of all contracts. A procedure should be developed to ensure that only one contract is in-force for each group to avoid litigation issues.

Generally, there is no policyholder verification performed by the district office when a new member of an existing group association requests a new policy to be written. This process is a breach of SCIF's underwriting standards. An underwriting policy should be developed that requires verification with the group administrator that the policyholder is a member of the group before the discount is applied or shortly after within a 60 day period. On September 12, 2007, SCIF management informed us that they are reviewing broad aspects of the group program for improvements.

A lack of established procedures and guidelines allowed for the signing of group administrative contracts without proper oversight by the SCIF Marketing Manager or review by the legal staff. Procedures should be established that clearly define the group association contract review process. The Legal Department should be actively involved in monitoring compliance. SCIF executives are currently making changes to the contract review process with assistance from outside counsel. As the procedures evolve, all departments should be informed of the new policies and these procedures should be strictly enforced.

There were some administrative fee checks paid to the individuals who administer the groups instead of to the group associations. All checks to group associations should be made out to the group association, not to the administrator of the group association.

In addition to Board members being affiliated with the group associations, former SCIF employees administered some group associations. SCIF should develop policies to address the administration of associations by former SCIF employees in order to avoid potential conflicts of interests. Conflict of interest statements should be reviewed by the Legal Department to ensure that all potential conflicts are addressed. The state appointment process should assure that conflicts of interest do not exist for future Board appointments.

Group administrative fees paid to associations were classified incorrectly as legal and auditing fees in SCIF's financial statements. This classification was misleading to users of the financial statements. We recommend that these fees be classified in total as a write in for miscellaneous expense on the NAIC Annual Statement. This will promote transparency.

Information Technology

Based on the SCIF responses, evidence examined, control validation performed, and the business application walk-throughs conducted, we believe the overall SCIF IT control environment needs to be re-organized and improved. Control risk in certain areas of IT governance, logical security and computer operations is considered high. Various policies and procedures are not being updated and/or followed in all the environments reviewed.

There has been turnover in the management staff overseeing the IT Department. The IT Program Manager transferred to another position in October 2007. Another IT staff member assumed the role of interim IT Program Manager. SCIF should engage an outside consultant to assist with the oversight of the IT Department until a permanent Chief Information Officer position is established. As there are significant IT matters to address prospectively, SCIF should look for more effective leadership in this department.

There have been IT control reports, with findings, issued by third parties and SCIF's internal audit team that have remained open for more than a year. SCIF's management responses to these exceptions were not fully documented and detailed workpapers were not presented. Internal and external audit IT exceptions should be prioritized by management in a timely manner to address remediation issues. These action steps should be documented in the IT files for reference.

IT procedures are fragmented and several key policies have not been approved by senior management. The absence of formal implemented policies limits the effectiveness of IT Governance. All IT related policies should be updated and submitted for senior management approval. Once approved, these procedures should be implemented and monitored. Additionally, communication policies between the district and home office should be formalized so that all parties are aware of the protocol.

SCIF has not developed a detailed plan for the Vacaville migration project. SCIF management stated that the details of the project will be included in the 2008 IT budget. The contracts and expense budgets for the Vacaville Data Center should be reviewed by the Board and/or financial experts to assess the accuracy of assumptions in the budget for each phase. The budgets for the data center migration costs should be documented in more detail to ensure that expense calculations like project supervision, decommissioning of old data centers and engagement of consultants can be analyzed.

The Enterprise Security Group is not formally empowered to enforce use of IT resources with other programs that are part of the organization. This lack of empowerment results in critical events or actions relating to security of the systems being executed without proper supervision and assessment by the Enterprise Security Group. The role of SCIF's Enterprise Security Department should be evaluated in order to permit the security group to act as an enforcer of SCIF's IT policies. Security best practices should also be integrated into the IT policies on an enterprise-wide basis.

Several users across different departments of SCIF are authorized as 'super users' over the General Ledger and other modules of the Oracle Financials application. This type of function (module super users) allows the execution of critical commands and queries on the modules and should be centralized and not shared. These IT segregation of duty issues could lead to possible data integrity issues, failure to allocate resources effectively, unauthorized access to financial data and confidential information that could result in possible fraud or misstatement. Oracle monitoring reports are not being reviewed on a consistent basis. SCIF should make several enhancements to its Oracle system. The Oracle segregation of duties should be reviewed and revised. User criteria in Oracle, including the functions of preparing, approving and receiving should be assigned separately to provide for segregation of duties. The Oracle software has extensive exception reports available that would be valuable to SCIF; these reports should be enabled. Oracle audit trails from critical systems must be reviewed on a periodic basis with exceptions followed up by the Enterprise Security Group.

Business recovery plans are not current or standardized. SCIF should perform a review of its computer operations functions to ensure that business recovery plans are updated, tested, and standardized throughout the organization. Data center physical and logical security should be enhanced to protect equipment from damage and to safeguard the center from unauthorized access.

District Offices and Claims Processing Centers

SCIF has several district offices throughout the state. These district offices provide many services, including policy underwriting, claims adjudication and loss control functions. We visited four district office locations and three claims processing centers to conduct interviews with key personnel, perform walk-throughs of key systems and processes, and test key attributes for policy and claims functions, and reserving practices.

The medical bill payment function for all district offices was moved to three claims processing centers located in Fresno, Fairfield and Burbank. SCIF executives stated that the reason for this transfer of duties was to create a central location for processing these payments and housing these services in locations that are easier to attract and retain employees. Since the transition of bill payments to claims processing centers, medical and indemnity bill penalties paid for all district offices have increased significantly to \$19.5 million in penalties from January 2007 through July 2007, with \$4.7 million occurring in July alone. Budget cuts were made to these facilities contrary to the recommendation of the SCIF Board Chair and the Vice President who assumed management of these facilities. SCIF should address problems at the

claims processing centers that resulted in significant late payment penalties. In August 2007, SCIF hired a consultant to assist with this matter and hired temporary staff to address the processing backlog.

A lack of evidence existed in a portion of the claims sample regarding the proper review and approval of case reserves. A formal claim evaluation process has not been established. Management should sign-off on the case reserve balances to indicate that the reviews, performed at least annually, and the case reserves were properly recorded. Establishment of a quality review function would enhance SCIF's ability to evaluate individual performance, identify training opportunities, and establish and monitor metrics across the organization. Additionally, procedures should be developed to ensure that all known medical costs are considered when case reserves are established and that actuaries are made aware of medical bill processing delays when determining reserves. Case reserves estimated by the claim adjuster are often modified as medical bills are received instead of establishing case reserves based on the adjusters best estimation of cost. A report is generated detailing claims in which medical bills paid exceed the reserve. These claims are the focus of routine reserve revisions. Due to the processing delay of medical bills received at the claims processing centers, there seems to be a consistent delay before case reserves are revised in response to the medical bill. This practice may result in understated case reserves for known medical costs. Consistent methods should be followed to monitor timely completion of case reserve estimates.

The implementation of the Electronic Claims File (ECF) Software was not as effective as SCIF had planned, which partly was the result of budget cuts. It is important that budget cuts align with strategic business plans developed for training and development. Additional training should be provided so that new or reassigned claims personnel are proficient with the ECF software and enter consistent and accurate claims data. Also, Internal Audit should conduct reviews of the district offices' implementation of this software.

Business Services

Business Services has operations in the home office as well as in the Fairfield, Pleasanton and Chatsworth district offices. Business Services is comprised of four units, which consist of operations, purchasing/transportation/supply, telecommunications, and business applications. Business Services is also responsible for the contracting and payment of IT vendors. Approximately \$321 million was paid to IT vendors since 2004.

The Business Applications Unit was transferred from the Business Services Department to the Fiscal Department on the last day of testing, which was September 11, 2007. SCIF has indicated that management in the Fiscal Department is conducting its own independent review and will implement enhanced control procedures once the integration of the unit is complete.

SCIF has more than 2,000 fleet vehicles for a total of 8,000 employees. In spite of the significant cost of acquisition and maintenance of this vehicle fleet, SCIF has not performed an audit of Fleet Management since 2003, and the 2008 approved Internal Audit plan does not include a review of Fleet Management. An internal audit of the fleet car pool should be performed. An analysis of the need for fleet vehicles should be considered to determine whether all of the vehicles owned or leased by SCIF are necessary. On a periodic basis, the fleet manager should also perform an audit of the SCIF Monthly Travel Logs for compliance with SCIF policy.

Several payments were made without a purchase order or a signed contract. All payments should be evidenced by an approved purchase order or a fully executed contract. Payments should be evidenced by

an original invoice prior to payment. The formal policy covering employee expense reimbursements should be followed at all times. These transactions should also be subject to the audit and approval process in all instances.

IT vendor contract guidelines are general in nature and do not address key control procedures or outline IT, Business Services, HR, or the Legal Departments' roles in the vendor contract process. IT vendor contract guidelines should be updated to provide specific policy and procedures for the following areas: 1) review and approval of IT vendor contract service, 2) preparation and approval of IT vendor service requisitions, 3) solicitation and evaluation of quotations such as price, vendor reliability and vendor quality 4) review and approval of contracts by managers in the IT and Legal Department, 5) preparation and approval of purchase orders, 6) required procedures for a vendor background check and 7) accounting for IT vendor services such as capitalization and expenditures. Additionally, retention of contracts should be centralized at SCIF to ensure that original contracts, amendments and any other pertinent information are available. SCIF is working with outside counsel to enhance the IT vendor contract process.

Contracts for IT consultants used for operational purposes have been extended for years beyond the original contract term. The consultants have been used to augment the existing IT operational staff on a long-term basis, and not necessarily to fill temporary needs. The use of IT consultants to fill long-term operational needs circumvents the HR hiring process and may not be cost beneficial. Additionally, this practice distorts the true IT departmental staffing needs in the budgetary process, and may increase security issues. IT consultants that perform project development work are contracted over six month periods, and are not contracted by project. This practice circumvents both the HR hiring process and the vendor bid and selection process. By not requesting project bids, SCIF may not be receiving the best rates possible. The method in which IT consultants are employed should follow SCIF prescribed policies and procedures. IT consultants used for operational purposes should be utilized for short-term needs only. For long term needs, IT should work with the HR Department to develop an annual budget for utilization requirements. IT consultants used for project development purposes should be contracted by project through the use of a fixed fee bidding process that requires key objectives and deliverables be met by the vendor.

Payments made to certain IT vendors were not in compliance with contract terms. In one instance, payments made to a vendor and its affiliates totaled approximately \$100 million from 1996 to 2006. Even though the term of the contract expired in 1997, the vendor continued to provide services and SCIF continued to make payments through 2006. No additional amendments or contractual agreements were received to support the vendor payment history. In September 2007 SCIF filed suit related to these vendor contracts. All contract revisions should be filed with the master vendor contract file maintained and reviewed by the Legal Department.

SCIF engaged in business practices that allowed additional expenditures to be made to vendors which were outside of the Board approved budgeting process. This practice allowed SCIF to purchase goods or services and make charitable contributions that were not formally approved by the Board.

In addition, the internal investigators identified some unusual or abnormal invoices through vendor interviews and review of SCIF's e-mail system. The abnormal invoices did not represent advertising or marketing services that the vendor usually provided to the SCIF Marketing Department. The arrangement between the vendor and former SCIF executives was that the vendor would pre-bill SCIF for a specific amount and then use these funds to obtain goods and services from third parties as directed by the former SCIF executives. The current Board Chairperson stated that the Board was not made aware of this practice by SCIF executives. All employees should receive ethics training including information on how to report unethical practices. The practice of using encumbrances has been practiced at SCIF for some

time; therefore, employees need proper instruction on accruals and encumbrances in addition to training on proper budget techniques.

We were not able to complete the review of the fleet cars in the transportation unit or the review of the IT vendor process, due to timing issues related to the receipt of information from SCIF.

Summary of Significant Findings

Overall, SCIF has weak corporate governance, inadequate internal controls in various areas and a general inability to plan for the long-term. However, despite the limited tenure of the current Board of Directors and executive management team, SCIF has developed many initiatives that we believe will strengthen its corporate governance, internal controls, and financial and business planning. As part of SCIF's overall succession planning for its senior management team, the newly hired President, Janet Frank, assumed the role of President on October 9, 2007.

Because SCIF legislation was not passed in 2007, it is critical that SCIF implement an interim governance structure to ensure that appropriate reforms continue. The SCIF Board and executive management team will need to utilize provisional consultants coupled with existing permanent resources during the interim to continue progress on operational improvements. A governance structure cannot be effective if the Board lacks the necessary tools to provide appropriate oversight from the top down. It is essential that legislation be enacted soon to enable SCIF the ability to seek additional exempt positions and increase the size of its Board.

Specific Findings and Recommendations

Governance and Management Practices

Background

Management: SCIF is managed by an executive management team consisting of ten members, including the President, which operates in a committee style. This committee meets regularly to discuss issues and collaborate on strategic decisions. Functional operational units at SCIF are defined as programs within the organization. SCIF programs are each assigned to members of the executive management team for oversight. Decisions regarding which executive oversees a given program may depend on availability, rather than aligning the programs with a key executive's background or expertise.

SCIF executives and staff are state employees. The only exempt position at SCIF is the President. SCIF has been utilizing two consultants to fulfill the typical duties of a Chief Financial Officer, and these financial consultants will both be leaving SCIF by the end of 2007. In order for SCIF to attract qualified senior management, it must be able to compete with other firms in the market place.

Board of Directors: SCIF has a five member Board of Directors (Board), all appointed by the Governor. SCIF Board members are paid \$100 per meeting and are reimbursed for all related meeting expenses.

A Board of Directors' primary function is to provide management oversight. The Board is also responsible for evaluating the organization's strategic plans and objectives. Due to management changes, the Board assumed active management for certain day-to-day operations that typically would be the responsibility of management.

Modifications to the Board require legislation. SCIF proposed legislation in 2007 to increase its Board from five members to eleven. In addition, this legislation would have created six additional exempt positions. This legislation was not passed.

Governance Framework: SCIF has not adopted a formal governance framework. SCIF established a SOX Committee in March 2005 to review internal control processes of key accounts related to executive certification of periodic financial statement accuracy. The Risk Committee was formed in September 2007 to identify and assess critical areas of risk across the organization and to assure financial reporting integrity.

Human Resources: HR at SCIF provides services for approximately 8,000 employees.

Internal Audit: There have been enhancements in the reporting structure of Internal Audit since July 2006. The Internal Audit Program Manager previously reported to the General Counsel until March 2007. In this reporting structure, the Internal Audit Program Manager did not attend SCIF Board meetings and did not interact with the Board. This arrangement did not allow independent reporting by Internal Audit to the Board.

In March 2007, SCIF made enhancements to Internal Audit. To improve its independence and objectivity, Internal Audit now reports to the Board and administratively to the President. The Internal Audit Program Manager also now attends Board meetings and has executive sessions with the Board. The first Board

meeting that Internal Audit participated in was May 10, 2007. An audit charter was adopted at this meeting outlining Internal Audit's mission.

Findings and Recommendations

Based upon our review of governance and management practices, we identified the following findings and respective recommendations.

It is necessary for an entity the size and complexity of SCIF to have a solid management structure in place to ensure that governance principles are effectively and efficiently followed. SCIF should consider the following options as it realigns its management and governance structure. Based upon our review of management practices, we identified the following findings and respective recommendations:

Chief Officer Positions

1. SCIF Lacks Key Officer Positions

Finding

SCIF lacks key management positions that comparable insurance companies possess.

Recommendation

In order for SCIF to have an effective management structure, new exempt management positions need to be established. SCIF needs at least five additional exempt positions. These positions are Chief Financial Officer, Chief Information Officer, Chief Investment Officer, Chief Operating Officer and General Counsel. Legislation should be enacted to allow SCIF to create these five exempt positions in order for SCIF to compete with other firms to attract the most qualified individuals. It is important that duties for these executives be properly outlined. Other exempt positions may be needed as SCIF reorganizes other functions and enhances controls within the organization.

2. Use of Consultants

Finding

SCIF has been utilizing two consultants to fulfill the duties of the CFO position. These consultants will not be renewing their contracts with SCIF at year-end. SCIF does not have a plan for the assumption of these duties after year-end.

Recommendation

SCIF should retain a consultant to assume the CFO duties by year-end. The earliest that legislation could be adopted to provide for a permanent CFO position would be in 2008. Additionally, SCIF should appoint someone in the Fiscal and Investment Program to work closely with the selected consultant to ensure that institutional knowledge is retained.

3. General Counsel Role and Reporting Structure Needs Revision

Finding

The General Counsel reporting structure may have allowed the President to have too much influence over the General Counsel and compromise the position's authority and utility.

Recommendation

SCIF should revise the reporting structure and duties of the General Counsel position to report administratively to the President, but functionally to the Board of Directors. The Board should be ultimately responsible for this function. The General Counsel should attend all Board meetings and be permitted to have executive sessions with the Board members. The General Counsel should also help define what authority the Board delegates to committees from a legal perspective. The position should also assist the Board in identifying when outside specialists are needed.

Board of Directors

4. Increase the Size of SCIF Board, Review Director Qualifications, Training Curriculum, Compensation and Meeting Frequency

Finding

The SCIF Board has only five members which makes it difficult to form committees, as the same members would sit on all committees due to the Board's limited size.

There are minimal qualification provisions for Board members in the insurance code. This creates difficulties in obtaining a diverse Board. The Board's compensation structure is below other comparable boards for an entity of this size and complexity.

Board member training is conducted informally at the discretion of the Board Chair. SCIF employees typically design training curriculum for Board members at the Board's request.

Recommendation

Significant changes should be made to the Board. The size of the Board should be expanded. Board terms and qualifications should also be reviewed and revised. The Board should ensure that conflicts of interest do not limit members' capacity to function effectively. It is important that the majority of Board members have diverse qualifications with base line insurance knowledge. SCIF should consider having an investment expert represented on the Board as well as a legal expert. The appointment process should assure that only highly qualified individuals, without conflicts, are considered for appointment to the SCIF Board.

SCIF is a unique organization that operates in a specialized market. It is important that SCIF develop a training curriculum for Board members. This training program should be approved by the Board Chair. All Board members should be required to complete this training. Board training should include corporate governance and ethics. Additionally, Board members should participate in educational sessions annually related to trends in the workers' compensation market.

Once the expanded Board is filled, the Board should be divided into committees to conduct business more effectively. Earlier this year, SCIF formed an audit committee. Budget, governance and compensation committees should also be formed to address current issues and provide effective oversight.

In order to attract and retain qualified Board members, SCIF should review the Board members' current compensation structure to bring it in line with comparable organizations.

It is noted that these Board modifications require changes in legislation.

5. Establish Benchmarks for Board Reporting

Finding

Certain Board budget directives were not followed by SCIF executives. SCIF has not developed standard reporting parameters for consistent communication and reporting to the Board.

Recommendation

The Board should develop a mechanism to ensure that pertinent financial information, including budget information and other related matters of importance, is presented and approved by the Board on a regular basis. Set parameters for Board reporting should be approved and followed by SCIF executives. The Board should appoint one executive to be the responsible party for this information. It is recommended that the President or General Counsel assume this role. Additionally, the Board should ensure that information is received from an array of executive officers so that the entire management team's expertise is fully utilized.

Governance Framework

6. Adopt a Governance Framework

Finding

SCIF has not adopted a formal governance framework. SCIF established a SOX Committee in March 2005 to review internal control processes of key accounts related to executive certification of periodic financial statement accuracy.

Recommendation

SCIF should adopt a framework for corporate governance that outlines a structure for effective internal controls. The NAIC Model Audit Rule or the Sarbanes Oxley Act of 2002 may serve as models for SCIF regarding monitoring and control over financial reporting. SCIF should consider objective standards such as COSO and COBIT. A plan for all internal controls, not just financial reporting controls, needs to be implemented. This framework should ensure that all risks are monitored. If necessary, SCIF should consider another position for a Compliance Officer who would be responsible for compliance with state regulations. An annual compliance report, certified by SCIF executives, should be considered to make certain that adequate Board and management resources are dedicated to improving and maintaining an effective control environment at SCIF.

General Management Practices

7. Enhance Existing Internal Committees

Finding

SCIF executives formed a committee to address risk management issues. However, it was unclear if the SOX Committee would disband and be reconstituted under this new committee.

Recommendation

It is recommended that SCIF retain both committees. The Risk Committee should be reviewing and monitoring potential prospective risks, as well as current risk indicators, while the SOX Committee should continue to focus on internal control enhancements.

8. Executives Should be Actively Involved in Monitoring Interim Consultants

Finding

Certain members of the Executive Committee were not fully informed on the use of key consultants.

Recommendation

The Board and the President should ensure that executives and staff working with consultants understand the scope of the consultant's engagement. Executives that have primary oversight responsibility for consultant use should have regular communication with the consultant, and apprise the President regularly on the status.

9. Improve Communication Throughout the Organization

Finding

An improved communication process needs to be implemented throughout the organization.

Recommendation

SCIF management should take an active role in communicating corporate changes, both formally and informally, as it interacts with staff. A formal communication strategy should be developed and approved by the Board.

Human Resources

10. Establish Formal Succession Planning

Finding

SCIF does not engage in a formal succession planning process.

Recommendation

Strategic succession planning is critical for SCIF, as many of its staff near retirement in the next few years. HR should work with the Executive management team to develop a formal succession plan.

11. Accurate Recordkeeping for Vacation Accruals

Finding

There is no formal vacation policy or vacation time reporting structure for program managers and executives. Two significant payouts were made to former employees for unused vacation time.

A vacation balance for one former executive was over 3,300 hours and for another former executive the vacation balance was over 2,100 hours.

Recommendation

SCIF employees must submit a form complete with the dates and hours of vacation requested with the employee's signature and the supervisor's signature. This policy should be followed by all staff in the organization. HR should perform a reconciliation to verify that accruals accurately reflect vacation time used by employees. SCIF should follow the state prescribed vacation and annual leave policies. If exceptions are made permitting employees to go over the designated

accrual limit, proper approval and related documentation should be maintained. Significant deviations should be reviewed and documented from both a legal and business perspective.

12. Procedures Should be Established to Safeguard SCIF Assets and Information

Finding

There is no established procedure to ensure that company issued equipment, SCIF property or records are returned upon an employee's termination or resignation. HR does not regularly communicate directly with the IT Department to provide notification of terminated employees. Program Managers and others notify IT through different means without following specific procedures.

The same practice is followed for employees that are promoted or transferred into different programs. Due to the lack of controls in place within IT, employees may be granted multiple accesses to various software tools or information outside of their current employment and terminated employees may still have access to SCIF systems.

Recommendation

HR should develop a written protocol to safeguard SCIF's assets and proprietary information when an employee is terminated, resigns or transfers to another position within the organization. It should be the Enterprise Security Department's role to ensure that employee access to systems has been terminated or revised timely. SCIF is enhancing procedures in this area.

13. Performance Management Standards Need to Be Enhanced

Finding

Performance evaluations are not conducted consistently throughout the organization on an annual basis. Also, job descriptions are not updated regularly.

Recommendation

HR should enforce the SCIF policy that evaluations be conducted annually. SCIF should conduct training for supervisors on how to prepare an effective performance assessment. Job descriptions need to be updated on a rotational basis to accurately reflect position duties.

14. Improve Human Resources Function at the District Offices

Finding

District office management currently performs typical HR responsibilities. HR confirmed that its involvement with the district offices is limited. The rationale provided for this process is that the district offices are decentralized, and the lack of HR involvement was part of the corporate plan.

Recommendation

HR should oversee all related matters that fall under its supervision, not just those that are at the SCIF home office. HR should visit district offices and participate in oversight. The SCIF Employee Handbook should be reinstituted as a tool for employees.

15. Improve File Retention and Maintenance of Human Resource Files

Finding

Many HR files that were reviewed lacked complete documentation or were missing in their entirety. In certain instances, missing documentation included information on retirements, resignations,

terminations, and promotions. The missing and incomplete files are not in compliance with SCIF's HR retention policy. Although SCIF stated that these files/documents were most likely 'checked-out' by other department personnel, there was no evidence to verify this statement, and the missing files were not located.

Recommendation

The HR personnel file maintenance system needs to be updated. A more secure file checkout process could be accomplished electronically with files linked to employee profiles in Oracle, or manually with increased HR employee oversight. Internal audit should also conduct a review of HR files within the next year to verify that file maintenance has improved. It is recommended that HR files be scanned and backed up electronically.

16. Develop Leadership Training

Finding

SCIF offers many training courses that are technical in nature or that are created to satisfy a current initiative such as a change in regulation. There are very few formal leadership training courses available at SCIF that address soft skills for managers.

Recommendation

HR should work with the SCIF Board and executives to develop a comprehensive training program, including leadership training for future managers and additional soft skills training.

17. Re-Establish Exit Interview Process

Finding

Due to the large number of employees that have been leaving SCIF, HR discontinued the exit interview process.

Recommendation

An exit interview should be conducted for all employees. Exit interviews can be helpful in understanding the morale of employees and also serve as a useful tool in retention and measuring organizational changes. HR should administer all exit interviews, conducting phone interviews as appropriate for employees vacating positions located outside the home office. The exit interview should be maintained within the employee's personnel file with results shared with the respective program manager and the appropriate executive staff.

Internal Audit

18. Enhance Risk Planning Model

Finding

Internal Audit develops its risk planning model primarily from internal assessment surveys and NAIC branded risk classifications. There was no external reference to market conditions reflected in the risk planning model.

Recommendation

Internal Audit should continue to refine its risk planning model. Consideration should be given to regulatory issues and industry market conditions that may not be reflected in the responses collected from management. Internal Audit should conduct an independent assessment of these

areas and factor this into the risk planning model. The Board should also assure that Internal Audit resources are adequate to address the risks facing SCIF.

19. Enhance Internal Auditors' Understanding of IT Standards

Finding

Based upon discussions held with Internal Audit personnel, the IT auditors do not have a strong background in IT.

Recommendation

Although the newly formed unit, Special Projects/External Unit, in Internal Audit allows for the contracting of IT specialists when needed, SCIF should require additional training for existing IT auditors in the area of Information Systems and COBIT standards.

20. Improve Audit Follow-up and Implement Central Repository for Open Findings

Finding

SCIF performs audit follow-ups with the auditee at 90, 180 and 365 days after the audit report date, with management responses due within 10 business days. Although Internal Audit is required to conduct these audit follow-ups, Internal Audit does not maintain a central log of open issues and findings. The auditor in charge tracks the follow-up dates via an MS Outlook calendar or bulletin board posting, as well as on the newly revised Project Review Form (PRF).

Recommendation

The implementation of post-audit follow-up is a useful step for Internal Audit in eliminating repeat findings and ensuring that recommendations are addressed by auditees. Internal Audit should create and maintain a central log of open findings. They should designate a staff member to track these findings for the entire department, and retain the applicable documents from the auditee such as newly created policies or procedures suggested in the audit report. Additionally, the Audit Committee of the Board should receive a copy of these logs to note which audit recommendations are still open or are in progress and to determine which audit issues have not been properly addressed. We also recommend that the Audit Committee adopt a formal policy on how open audit issues should be addressed.

On September 17, 2007, Internal Audit implemented a procedure to maintain a central log of open findings.

21. Improve Workpaper Documentation

Finding

The Internal Audit Manual states that each workpaper should have a heading, the name of the auditor performing the work, the date, workpaper purpose, audit source and a conclusion. In general, the SCIF Internal Audit workpapers lacked headings, purposes, audit dates and conclusions.

Recommendation

The Internal Audit Program Manager should ensure that Internal Audit staff is following standards set forth in the Internal Audit Manual. Specifically, internal audit workpapers should contain a heading, purpose, audit date and conclusion. Audit workpapers should be easy to interpret and provide support for the audit performed.

22. Update Project Review Forms

Finding

Internal Audit staff prepare a Project Assignment Order (PAO) in the planning phase of the audit to document the audit plan, which includes the estimated completion date of the project and a Project Review Form (PRF) at the completion of the audit to document the completion date, whether follow up is needed, actual hours incurred and supervisory review of the project. Of the 47 audits reviewed, 19 audits were missing follow-up dates, 13 audits contained large variances between the budget to actual hours with no explanation of the variances, 10 audits had no actual hours populated, and three audits contained large variances between the planned and actual completion dates with no explanation of the variances.

Recommendation

Internal Audit management should ensure that it has adequate data so that internal audits can be completed in a timely manner and within budgeted hours.

23. Strengthen Audit Recommendations and Monitor Management Responses and Repeat Findings

Findings

Report recommendations contain “soft” language such as: “remind” and “encourage.” Soft language does not lend itself to enforceable action plans, accountable individuals and target dates.

Recommendations with “soft” language coupled with poor responses from management lead to unaddressed risks and repeat findings. We also noted several repeat findings in our review of the internal audit reports.

Recommendation

Audit recommendations should use stronger language, such as “implement,” “complete” and “perform” in order to promote better responses with action plans and target dates.

Internal Audit should not accept responses that do not contain solid action plans, indicate target dates and identify responsible parties. Any responses lacking the appropriate language should be sent back to the auditee for revision. Internal Audit should also ensure that management responds to each and every recommendation.

Additionally, Internal Audit should consider incorporating management responses into the report as opposed to maintaining them in a separate document. This information should be reported to the Audit Committee in summary format.

24. Develop Sampling Documentation

Finding

The PAO addresses the need, objective, scope and procedures to be performed in the audit, and is approved by the Internal Audit Program Manager. Under the procedure section, the populations subject to sampling and the method of sampling (i.e., statistical or judgmental) are not addressed. In general, the workpapers lacked detailed descriptions of sampling methods utilized for test work.

Recommendation

Internal Audit should ensure that it is documenting the selection and justification for its samples and that the samples are sufficient to support the conclusions. The Internal Audit Manual should be updated to include documentation of sampling methods.

25. Provide Responses to Self-Reviews

Finding

The Internal Audit Manager did not respond to recommendations in self-reviews performed by members of the Internal Audit staff.

Recommendation

Internal Audit management should provide responses to self-reviews to ensure that the department, as well as SCIF as a whole, benefits from the recommendations provided in these self reviews.

The Internal Audit Program Manager indicated that, going forward, she will be providing formal responses to be distributed to the Board of Directors and Executive Committee.

26. Monitor Corporate Underwriting and District Office Self-Reviews

Finding

Many of the underwriting audits are performed as self-reviews by both the district offices and corporate underwriting personnel. Internal Audit has not monitored these self-reviews.

Recommendation

Internal Audit should monitor these self-reviews to ensure they are being appropriately conducted and documented. In addition, Internal Audit should ensure that action plans and dates that are developed as a result of these self-reviews are strictly followed. Audits of these self-reviews are planned for 2008 and on a rotational basis every five years thereafter. If the audits in 2008 yield poor documentation and follow-up, Internal Audit should consider assigning a resource to follow up on these self-reviews.

27. Implement Consistency in Supervisory Reviews

Finding

The use of coaching/review notes is inconsistent.

Recommendation

Internal Audit should make certain that there is consistency in regards to supervisory workpaper review. Once Internal Audit starts utilizing the TeamMate Audit Management System (electronic workpapers), coaching notes will be directly linked to the workpaper with the exception, and will require a response from the auditor who performed the work, as well as review by the supervisor in order for the comment to be cleared.

28. Standardize Audit Reports

Finding

The format and content of the Internal Audit reports varied greatly between units.

Recommendation

In order to ensure reports contain complete information and are easy to follow, Internal Audit should require that auditors follow a standard format for reports.

29. Include Explanations for Items Excluded from Audit Scope

Finding

Some internal audit reports outlined items that were not included in the scope of the audit, but there was no explanation as to why the excluded items were not covered.

Recommendation

If audit reports exclude certain items, an explanation should be provided.

30. Implement Grading Within Reports

Finding

Internal Audit reports do not use a grading or rating scale to measure the results of audits.

Recommendation

Internal Audit should utilize a grading or rating scale in order to track audit areas of greatest concern. These ratings could be a useful tool in developing future audit plans as this would direct the auditors to those areas that have had problems in the past.

31. Maintain the Integrity of the Audit Plan

Finding

Audits of Group Administrative Fees and Group Insurance were started in 2005, but were not completed. It was explained by the Internal Audit Program Manager that the person performing these audits was pulled off of the audits to assist with higher priority special projects.

Recommendation

Deviations from the audit plan should be approved by the Board or the Audit Committee.

Summary

SCIF should support legislation that allows for additional exempt positions and an increase in the number of Board members. As exempt positions are created or as additional consultants are utilized, the Board will need to make sure the findings noted above are being addressed. This, coupled with improving the communication process, will benefit SCIF.

Internal Audit should provide an independent objective assessment on the appropriateness of the organization's structure. The changes that SCIF has made to the oversight of the Internal Audit function enhance the overall risk management environment. However, as the revised reporting structure, internal audit charter, and new risk planning model are recent changes, we believe it is too early to evaluate the effectiveness of these changes.

Group Association Programs

Background

SCIF offers policyholders the option to join an association (i.e., group) in a variety of industries throughout California in order to obtain insurance through a group association plan, as opposed to an individual policy. All group policies receive a six percent discount. As this group discount can be combined with other SCIF discounts, employers save on their premiums by being members of an association.

Group associations are also supposed to provide safety services. Group associations are paid an administrative fee for their services. Group administrative fees paid since 1997 amount to approximately \$524 million. Group administrative fees were classified incorrectly as legal and auditing fees in SCIF's financial statements. The administrative fee is calculated based on a percentage of the estimated annual premium as calculated by SCIF. In many instances, little to no safety services, or few other services, were provided to the members of the associations being paid these administrative fees. The structure of the administrative fee calculation motivated the associations to increase their membership base (more premiums equate to more fees), not to increase the safety services provided to members. It is because of this that the administrative fee may be likened to brokerage fees.

The group association review consisted of attending interviews for the associations, reviewing the Tier One groups independently by analyzing financial data provided from the associations, and evaluating the general components of the group association programs at SCIF. The group association interviews are being completed in conjunction with Clarence & Dyer, LLP, a law firm retained by the SCIF Board of Directors to head SCIF's internal investigation of these associations. Clarence & Dyer serves as the lead on the group association interviews.

Prior to these interviews, Clarence & Dyer assessed the groups and determined that 23 groups should be considered Tier One. Tier One groups are those of higher priority. This assessment of Tier One status is due to dollar amount of fees paid to the group and/or potential conflicts of interest or other activity between the group and SCIF.

For all Tier One groups interviewed to date, we have sent requests to groups requesting pertinent financial information. With the financial information received, coupled with the information obtained from the interview, contracts and payments per SCIF, individual financial analyses are being performed.

Findings and Recommendations

Based upon our review of the administrative fee group program, we identified the following findings and respective recommendations:

32. Group Administrative Fees – Directors

Finding

From 1997 to June 2007, SCIF paid close to \$140 million in group administrative fees to Western Insurance Administrators. This association was controlled by an individual who also served as a Board member for SCIF from 2003 to 2006. For the same period, SCIF paid approximately \$125 million to associations related to Golden State Builders Exchange. Similarly, this association was controlled by an individual who served as a SCIF Board member from 2004 to 2006. Both of these board members resigned in 2006. The Board minutes indicated that there was no conflict of

interest. Effective October 1, 2007 the groups administered by Western Insurance Administrators were not renewed by SCIF. The CDI is referring these findings to the joint task force.

Recommendation

It is recommended that the Board take action to ensure that its members do not personally benefit, either directly or indirectly, as a result of decisions made by the Board.

SCIF indicated that corrective actions to be implemented by the Board include the development of a code of ethics policy for board members, officers and employees. This code of ethics will include, among other provisions, articles related to financial conflicts of interest and procedures for investigations of directors and officers concerning ethics complaints. SCIF also indicated that it is in the process of preparing an Employee Incompatibility Activities policy. The Board is scheduled to review and adopt this policy in the later part of 2007.

33. Excessive Administrative Fees Paid for Minimal Services

Finding

Based upon interviews with group administrators, some group associations were paid millions of dollars for merely sending members quarterly newsletters and providing few other safety services. In many instances SCIF wrote most of the content for the newsletters. The SCIF group contracts were poorly written, which allowed associations to provide minimal services and still be in compliance with their contract.

Recommendation

SCIF should develop contracts that require specific services to be performed commensurate with the administrative fees paid. In 2007 SCIF developed contracts that require specific performance of administrative and/or safety services.

34. Contract Expense Review Provision Not Exercised

Finding

The group contract provision that permitted SCIF to review group association expenses was not exercised.

Recommendation

SCIF should enforce the contract provision that allows for a review of group expenditures. Additionally, a new contract should be developed for the groups that allow SCIF to periodically audit the group associations for contract compliance.

35. No Internal Audits Completed on Group Association Program

Finding

No internal audit reviews were completed for the group association program despite the fact that it represented a significant portion of SCIF's business. The 2005 audit was never completed as SCIF allocated Internal Audit resources to other reviews that SCIF management indicated were higher priorities.

Recommendation

SCIF should regularly include a review of the group programs in the Internal Audit Plan. A review should be completed at least once every three years, prioritized according to the program's significance.

36. Multiple Contracts in Force for Group

Finding

There was one group association that had both a multi-year and one year contract signed. The group claimed that the multi-year contract was in-force.

Recommendation

SCIF should have the Legal Department retain copies of all contracts. A procedure should be developed to ensure that only one contract is in-force for each group to avoid litigation issues.

37. Group Association Payment Approval Based on Incomplete Support

Finding

Clarence & Dyer provides SCIF management reports on the groups based on interviews performed. This information is utilized by SCIF as a basis for determining whether to resume payments to the individual group associations.

As of September 5, 2007, we obtained a listing of groups that had been reviewed by the SCIF Board and Executives with decisions regarding whether they would be approved for payment or not (as prepared by a SCIF Workers' Compensation Insurance Technician).

According to the schedule, three groups (one main group) were approved for payment on August, 30, 2007. However, Clarence & Dyer conducted a follow up interview with these groups on September 4, 2007 in order to gather more information. This follow up interview focused primarily on specific safety-related services provided by the groups.

Recommendation

SCIF should not approve groups for payment until all applicable information is obtained from the groups and analyzed.

38. Lack of Verification of Group Membership at District Office

Finding

Generally, there is no policyholder verification performed by the district office when a new member of an existing group association requests a new policy to be written. This process is a breach of SCIF's underwriting standards. If a policyholder's class code indicates that eligibility for a group discount exists, the underwriter usually asks/tells the broker and assigns the policyholder to the group without question or confirmation of actual association membership. This could result in SCIF receiving fewer premiums (due to group discount) and paying higher broker commissions and group association fees.

Recommendation

An underwriting policy should be put in place that requires verification with the group administrator if the policyholder is a member of the group before or shortly after the discount is applied. The verification of the discount should take place within 60 days after the quote is

provided by SCIF. On September 12, 2007, SCIF management informed us that they are reviewing broad aspects of the group program for improvements.

39. Underwriting Guidelines for Groups Need Enhancement

Finding

While there are rules regarding eligibility requirements for policyholders' entry into a group, an exception was noted of inappropriate involvement on the part of a group association in the underwriting decision making process.

Recommendation

Underwriting guidelines need to be clear regarding the eligibility of policyholders for groups. Guidelines should be strengthened regarding the placement of ineligible members into group policies.

40. Group Estimated Contract Premium (ECP) and Administrative Fees – Lack of Adherence to Controls and Contract Requirements

Finding

SCIF had inadequate controls over the ECP which allowed for the payment of group administrative fees to groups that did not meet the minimum premium requirement, and payments which deviated from amounts owed under the contract.

Recommendation

Policies and procedures should be developed and followed for all contracts. Any exceptions made to newly established policies and procedures should be documented and approved by the SCIF President and the Board. The Legal Department should be actively involved in the contract review process and should approve any changes made to the standard contract. Any old contracts, should be terminated before any new contracts are issued with individual groups, to guarantee there are no overlapping contracts.

41. Lack of Contract Review Procedures

Finding

A lack of established procedures and guidelines allowed for the signing of group administrative contracts without proper oversight by the SCIF Marketing Managers or review by the legal staff. As a result of the 271 group contracts reviewed, the following items were noted:

- 26 contracts had no evidence of SCIF Marketing Manager signature
- 35 contracts were not provided for review
- 68 contracts had unidentified signatures instead of SCIF Marketing Manager signature
- 139 contracts were signed by the 'Acting Marketing Manager'. Of these contracts, only 13 were signed on days in which the SCIF Marketing Manager was noted as out of the office for vacation or sick time
- 4 contracts were signed by SCIF Marketing Managers

We confirmed with SCIF HR and with other SCIF Departments, that there was not an 'Acting Marketing Manager' policy to allow contracts to be signed when the SCIF Marketing Manager was out. This was a policy that only existed informally in the SCIF Marketing Department.

Recommendation

Procedures should be established that clearly define the group association contract review process. The Legal Department should be actively involved to monitor compliance. SCIF executives are currently making changes to the contract review process with assistance from outside counsel. As the procedures evolve, all departments should be informed of the new policies and these procedures should be strictly enforced.

The Vice President of Groups indicated on September 11, 2007 that the current process for the signing of new contracts has changed. He stated that he will be signing the initial contracts. He added that the President or any SCIF employee in a higher position (i.e., Executive Committee) may sign the contracts in his absence as well.

42. Communication of Advertising Responsibility to Groups Inconsistent

Finding

SCIF did not consistently communicate information regarding the group associations' responsibility for advertising.

Recommendation

SCIF Group Program communication regarding advertising should be consistent. Advertising requirements should also be listed and adhered to in the group contracts. A formal memo should be created by the Marketing Department and then be sent to all groups communicating any change in the allowance of advertising of the SCIF group insurance program.

43. Eliminate Conflicts of Interest for Group Association Administration

Finding

In addition to Board members being affiliated with the group associations, there were also former SCIF employees administering some group associations.

Recommendation

SCIF must develop policies to address the administration of associations by former SCIF employees in order to avoid potential conflicts of interest. Conflict of interest statements should be reviewed by the Legal Department to ensure that all potential conflicts are addressed. The state appointment process should assure that conflict of interests do not exist for future Board appointments.

44. Group Administrative Fees Paid to Individuals

Finding

There are some administrative fee checks paid to the individuals who administer the groups instead of to the group associations. While it appears this was the exception, rather than the rule, this is not a proper business practice.

Recommendation

All checks to group associations should be made out to the group association, not to the administrator of the group association.

45. Group Administrative Fees Classified Incorrectly

Finding

Group administrative fees paid to associations were classified incorrectly as legal and auditing fees in the SCIF financial statements. This classification was misleading to users of the financial statements. Certain Board members stated that they were not aware of this material misclassification.

Recommendation

SCIF should develop guidelines for the correct classification of group administrative fee payments. We recommend that these fees be classified in total as a write in for miscellaneous expense on the NAIC Annual Statement. This will promote transparency.

Summary

SCIF paid approximately \$524 million in group administrative fees since 1997. Of this amount, approximately \$140 million was paid to Western Insurance Administrators, an entity controlled by a SCIF Board of Director during part of this period. In addition, over \$125 million was paid to associations with which another director during part of this period had business relationships.

SCIF group contracts allowed group associations to be paid millions of dollars for providing minimal or no services. SCIF had the right under the contracts to review group expenditures, but no review was ever performed.

A lack of established procedures and guidelines allowed for exceptions to occur in the calculation of premiums and administrative fees, underwriting guidelines and contracting procedures.

Group administrative fees were incorrectly classified in the SCIF financial statements.

SCIF is implementing various controls to address the issues noted in this report. A new contract has been developed for the groups and a revised contract review process is being established by the Vice President of the Group Association Program.

Information Technology (IT) General Computer Controls

Background

We utilized the Control Objectives for Information and related Technology (COBIT) framework to facilitate an effective and efficient review of SCIF's IT control environment. COBIT is a widely accepted IT governance framework and supported toolset that allows managers to bridge the gap between control requirements, technical issues and business risks. COBIT was designed by the IT Governance Institute to assist in managing risk and control of the IT environment. Most large companies have structured their IT environment around this framework.

Based on SCIF's responses, evidence examined, control validation performed, and the business application walk-throughs conducted, we believe that the overall SCIF IT control environment needs to be reorganized and improved. Control risk in certain areas of IT governance, logical security and computer operations is considered high. Various policies and procedures are not being updated and/or followed in all the environments reviewed.

Findings and Recommendations

Based upon our review of the IT control environment and related IT controls, we identified the following findings and respective recommendations:

46. Lack of Permanent IT Program Manager

Finding

There has been turnover in the oversight of the IT Department. There is not a permanent IT Program Manager. The IT Program Manager transferred to another position as of October 2007. Another IT staff member assumed the role of interim IT Program Manager.

Recommendation

SCIF should engage an outside consultant to assist with the oversight of the IT Department until a permanent Chief Information Officer position is established. As there are significant IT matters to address prospectively, SCIF should look for more effective leadership in this department.

47. Prior Report Findings Remain Open

Finding

There have been IT control reports, with findings, issued by third parties and SCIF's internal audit team that have remained open for more than a year. SCIF's management responses to these exceptions were not fully documented and detailed workpapers were not presented.

Recommendation

Internal and external audit IT exceptions should be prioritized by management in a timely manner to address remediation issues. These action steps should be memorialized in the IT files for reference.

48. IT Procedures Not Formalized or Approved

Finding

IT policies and procedures are fragmented and many of the key policies have not been formalized or approved by management. This includes network policy, access control, applications security, data center policy, etc. The absence of formal implemented policies limits the effectiveness of the IT governance at SCIF.

Recommendation

All IT related policies and procedures should be updated and submitted for senior management approval. Once approved, these procedures should be implemented and monitored. Additionally, communication policies between the district and home office should be formalized so that all parties are aware of the protocol. COBIT control objectives should be used by SCIF to assure that policies and procedures adequately identify and address the risks.

49. Vacaville Project Budget Incomplete

Finding

SCIF has not developed a detailed plan for the Vacaville migration project. SCIF management stated that the details of the project will be included in the 2008 IT budget.

Recommendation

The contracts and expense budgets for the Vacaville Data Center should be reviewed by the Board and/or financial experts to assess the accuracy of assumptions in the budget for each phase. The budgets for the data center migration costs should be documented in more detail to ensure that expense calculations like project supervision, decommissioning of old data centers and engagement of consultants can be analyzed.

50. Enterprise Security Group Lacks Authority

Finding

The Enterprise Security Group is not formally empowered to enforce use of IT resources with other programs that are part of the organization. This lack of empowerment results in critical events or actions relating to the security of the systems being executed without proper supervision and assessment by the Enterprise Security Group (i.e., user access modifications or user permissions modifications).

Recommendation

The role of SCIF's Enterprise Security Group should be evaluated in order to permit the Security Group to act as an enforcer of SCIF's IT policies. Security best practices should also be integrated into the IT policies on an enterprise-wide basis.

51. Segregation of Duties Issues

Finding

Several users across different departments of SCIF are authorized as 'super users' over the General Ledger and other modules of the Oracle Financials application. This type of function (module super users) allows the execution of critical commands and queries on modules and should be centralized and not shared. These IT segregation of duty issues could lead to possible data integrity issues, failure to allocate resources effectively, unauthorized access to financial data and confidential information that could result in possible fraud or misstatement.

A formal separation between production system changes control and security monitoring functions does not exist at the Orange County District Office, as these responsibilities are performed by the same individual.

Oracle monitoring reports are not being reviewed on a consistent basis.

Recommendation

SCIF should make enhancements to the Oracle system. The Oracle segregation of duties should be reviewed and revised. User criteria in Oracle, including the functions of preparing, approving and receiving should be assigned separately to provide for segregation of duties. The Oracle software has extensive exception reports available to SCIF. These reports should be enabled. Oracle audit trails from critical systems must be reviewed on a periodic basis with exceptions followed up by the Enterprise Security staff.

52. Business Recovery Plans Outdated

Finding

Business Continuity and Disaster Recovery plans were not current or standardized. In addition, several data centers were not properly protected from the elements, and access to computer rooms was not appropriately restricted.

Recommendation

SCIF should perform a review of its computer operations functions to ensure that Business Continuity and Disaster Recovery plans are updated, tested and standardized throughout the organization. Data center physical and logical security in all offices should be enhanced to protect equipment from damage and to safeguard the center from unauthorized access.

53. Standardize Change Management and Formalize Procedures

Finding

Change management documentation is not standardized. This has been an open external audit report issue since 2005.

The Enterprise Security Group does not have a sufficient active role in the review and approval of critical systems changes.

Recommendation

The Change Management documentation process should be standardized. Instead of utilizing a paper form for certain changes, the automated tool (People Soft Change Management module) should be used for all types of changes.

The Enterprise Security Group should have a more active role in the supervision and approval of critical systems changes as the inherent risks of the Change Management/System Development Life Cycle (SDLC) process are closely related to this discipline.

54. User Administration Procedures Not Formalized

Finding

The SCIF Logon and Application User ID/Password methodology and procedures are not formalized. There is not a designated entity or person in charge of ensuring that all departments regularly review the users' access to their systems.

SCIF's process for setting up users is informal. There is little correspondence between HR and IT to set up the users.

There is also no set coordination and communication between HR and IT for the termination of users' access rights. SCIF does not have a standard process to terminate user access.

Recommendation

Policies and procedures related to user account management should be documented to describe in detail a standard authorization and set up process for the SCIF systems. A standardized user access report should be produced for all the critical systems. The report should be reviewed and approved by the data and systems owners on a regular periodic basis.

Policies and procedures related to user account creation should be documented to describe in detail a standard authorization and set-up process on the systems. IT and HR should both play a role in this process.

User termination on the SCIF systems should follow established procedures. The termination process should be consistent throughout the organization, including the district offices. This process would commonly be initiated by HR communicating to the Enterprise Security Group

regarding the employee termination. Enterprise Security would then be responsible for terminating all user system access rights.

55. Non-Authorized Software and Applications on Workstations

Finding

Non-authorized applications are installed on most of the desktops in the Bay Area and Fairfield District Offices, as well as the Burbank Claims Processing Center. In addition, there are network packet capture tools, referred to as “sniffing tools”, on several computers in the Bay Area and Fairfield offices. These tools can be utilized to monitor all ingoing and outgoing network information and data, through computer surveillance technology, as well as all e-mail activity for the offices.

Recommendation

A strict policy should be enforced over non-authorized software and application installation by employees. The policy should consider the monitoring of installed software and the removal process. Also, sanctions for the violation of this policy should be communicated to employees. All staff should acknowledge their awareness of the policy.

In September 2007, SCIF executives began implementing a policy to address this issue. The new policy and corresponding controls should be tested once implementation is deemed final.

56. Oracle Procurement System Approval Limits Not Reviewed

Finding

No documentation exists to support how user limits are established. The Oracle system is set up to allow for up to a \$100 million entry without further approval.

Recommendation

Approval limits should be reviewed and criteria for limits should be defined.

In September 2007, SCIF Executives stated that new range limits were implemented for each functional position. However, user access criteria and appropriate range limit criteria were still in development.

57. Procurement Settings Not Reviewed

Finding

No email or communication message is sent to the preparer/approver when a requisition is cancelled. Unless the preparer/approver runs a report of cancelled requisitions, no warning of a cancelled requisition is received by the preparer/approver.

A cancelled requisition can be copied to a new requisition and moved to the shopping cart interface for processing without any additional approval requirements as long as the requisition does not exceed the preparer/approver’s purchasing authority.

Subsequent to our testwork, SCIF implemented compensating controls that address the segregation of the preparer and approver rights and functions. These changes have not been tested.

Recommendation

A review should be performed of the settings and configuration of the Procurement system. Formalized requisition procedures should be established to include:

- An audit trail of preparer/approver
- Monetary restrictions
- Preventative controls to eliminate the re-use of cancelled requisitions

58. Oracle Audit Logs Not Consistently Reviewed

Finding

Oracle monitoring reports are not reviewed on a consistent basis. The Oracle software has extensive exception reports that would be valuable to the IT environment at SCIF.

Recommendation

Audit trails from critical systems should be reviewed on a periodic basis. Furthermore, identified exceptions should be documented and followed up by the Enterprise Security Group.

59. Password Settings Not Standardized

Finding

The password settings vary through the different applications deployed at SCIF. Some of the inconsistencies identified on the password settings are:

- Passwords do not expire
- Password expiration time frames vary
- Password complexity is not required on all applications
- Password length is not in accordance with established policies
- Shared passwords

Also, the Oracle database default profile password settings are set to unlimited. These types of settings are not recommended as they increase the risk of security violations in the Oracle environment.

Recommendation

All password settings for critical applications and systems should be reviewed and established in a way that complies with the recommended security settings established by best practices.

60. User Recertification Process Deficient

Finding

The annual audit in the Bakersfield District Office called the "Enterprise Security Annual IDs Audit" that compares the SCIF LAN ID with the application did not include a review of the system privileges assigned to users.

Recommendation

A user access review and approval recertification process should be performed at least every six months. Data owners should be required to sign a user access review document, which should detail the name of the staff and the authorized functions for each employee based on a "least privilege" criteria.

61. Internet Access Monitoring Not Performed

Finding

Internet access monitoring functions in the Burbank District Office are not being performed uniformly for WEB access to unauthorized sites. Virus alerts and detection is being performed by McAfee software. The Bindview security application software is no longer utilized for WEB security monitoring; security monitoring is only performed upon the notification of a security issue with an individual from HR to the Burbank IT.

Recommendation

Formalized internet monitoring should be enabled to track unauthorized access attempts.

62. Security Management Access Not Restricted

Finding

British Telecomm (BT) Global Workstation security and access administration software for the entire PC desktop data and applications should be restricted in all offices. Access to this application has been granted to 15 Home Office individuals, in addition to the Los Angeles District Office staff of 32 people.

Also, user security and access procedures and reconciliation reports are not being consistently performed. The Active Directory contains 276 User IDs and the security profile data base log contains 138 entries.

Recommendation

User access procedures should be created to ensure authorized access is restricted for the following:

- BT Global Workstation Administration security
- PC Desktop Data
- Applications

Active directory user access procedures should be established to make certain that current IDs belong to active employees and any unauthorized access is revoked in a timely manner.

63. SCIF Anti-Virus Policy Not Formally Approved

Finding

The Anti-Virus policy is not formally approved. A report generated on September 7, 2007 determined that although 11,400 units are protected, over 2000 desktops are not protected. Currently, the nature of these unprotected workstations is unclear. An investigation was initiated by the Network Security Group.

Recommendation

SCIF should prepare, approve and implement a written anti-virus policy to ensure that all workstations on the SCIF network are protected from viruses.

64. Data Tape Encryption Not Performed

Finding

Data that resides on the backup tapes is not encrypted. According to the Data Center Manager, there is a corporate initiative to encrypt all data tapes within the next year.

Recommendation

The initiative to encrypt all data tapes should be completed within a set timeline.

65. Performance and Capacity Monitoring Not Performed

Finding

According to the Data Center Manager, the nature of the monitoring strategy of the data center is reactive rather than proactive. Besides a report of uptime for equipment and services, there does not appear to be robust reporting of performance and capacity monitoring that is communicated to upper management. Without this information, decision makers will be challenged to properly assess budgets and capacity planning.

Recommendation

SCIF should assess upper management reporting needs. Per the Data Center Manager, there is a corporate initiative to utilize a more robust monitoring for performance and capacity, to be installed with the new data center. This initiative should be completed within a set timeline.

66. Data Center Physical Access Activity Not Reviewed

Finding

There is no periodic review of the physical access activity to the SCIF Home Office Data Center.

Recommendation

Physical and logical access restrictions should be enhanced to include logging and monitoring of access, and prevention of unauthorized access.

67. Data Center Physical Security Not Monitored

Finding

There are no cameras for surveillance in the Fresno Claims Processing Center data center. Also, two access cards were identified for contractors without an appropriate deactivation time limitation (badges expire 2010). The IT system servers sit on the first floor (bottom level). There is no water detection controls and the floor is not raised.

In addition, there is no formal recertification of access to the data center or other sensitive areas such as the check printing room. There is no formal review of activity access to either data center or the printing room.

Recommendation

SCIF should strengthen the physical security at the data center. The Data Center Manager should sign a user access review document which should detail the name of the staff and the authorized functions for each employee based on a "least privilege" criteria. Access cards should be reviewed regularly to determine if the deactivation date is appropriate.

68. Home Office Help Desk and Support Not Monitored

Finding

A review of help desk tickets indicated that many tickets were not yet closed, some from January 2007.

Recommendation

Help desk tickets should be monitored and closed in a timely fashion. The help desk ticket monitoring should be performed centrally where problems occurring throughout SCIF can be identified and addressed.

69. Physical Security Access Cards Not Reviewed

Finding

The card access list for the SCIF home office with the users and access types is not accurate.

Recommendation

SCIF should review and update the access cards on a periodic basis.

Summary

Based on SCIF's responses, evidence examined, control validation performed, and the business application walk-throughs conducted, the overall SCIF IT control environment should be re-organized, reviewed and improved. The control risk on certain areas of IT governance, logical security and computer operations is considered high. Various policies and procedures are not being updated and/or followed in all environments reviewed.

The areas that are currently considered to be high risk:

- Failure to allocate resources effectively.
- Unauthorized external or internal access to resources and data may result in various exploits, potential fraud, or access to sensitive information.
- Data destruction and/or systems malfunction.

District Offices and Claims Processing Centers

Background

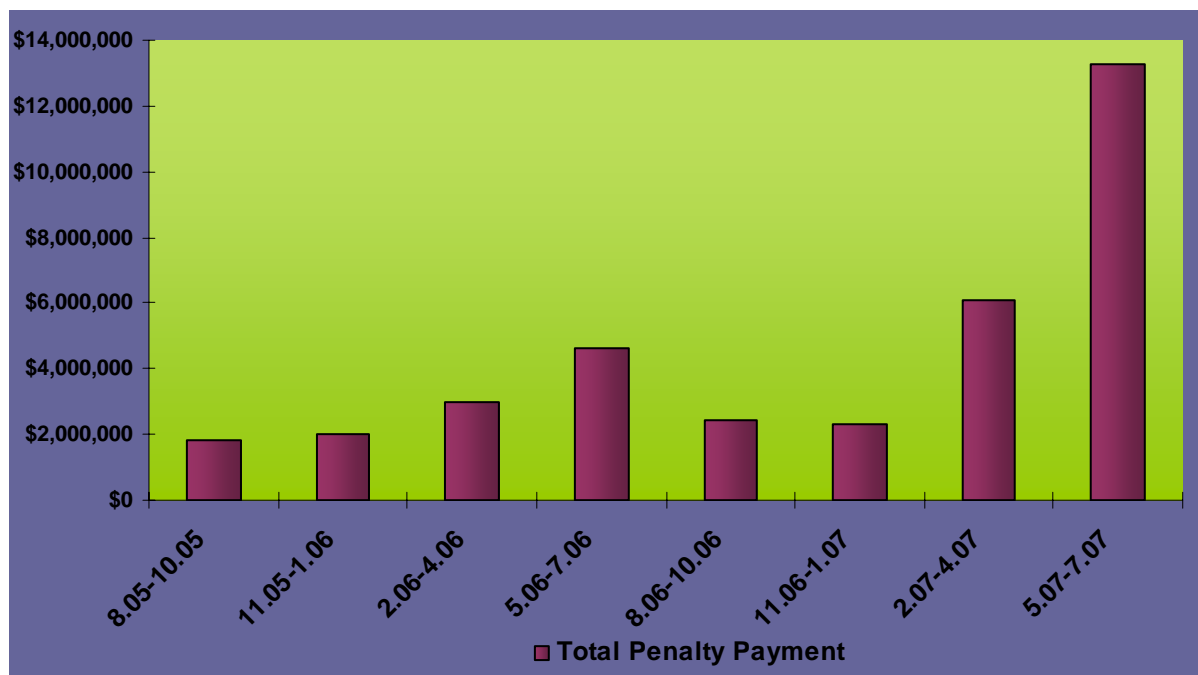
SCIF has several district offices throughout the state. These district offices provide many services, including policy underwriting, claims adjudication and loss control functions. We visited four district office locations and three claims processing centers to conduct interviews with key personnel, perform walk-throughs of key systems and processes, and test key attributes for policy and claims functions, and reserving practices.

During 2007, several district offices were merged. A District Reorganization Oversight Committee was created in March 2007 to guide the development and implementation of the new district office structure. This Oversight Committee is working with a Project Steering Committee of designated Program Managers to develop a model for all operations with separate policy and claims functions. A functional

project team for policy and for claims has also been formed to share research and recommendations on processes and procedures in their functional area. These teams ensure statewide consistency in product delivery while still allowing flexibility to respond to local issues and reports, and report to the Project Steering Committee. In addition, regional implementation teams have been identified in each location by the district managers to address specific issues, such as employee assignments, reporting relationships and location logistics.

The medical bill payment function for all district offices was moved to three centrally located claims processing centers in Fresno, Fairfield or Burbank. The rationale for transferring these duties to the three processing centers was to have a central location for processing these payments and house these services in locations where it is easier to attract and retain employees. However, since the transition of bill payments to claims processing centers, medical and indemnity bill penalties paid for all district offices have increased significantly to \$19.5 million in penalties from January 2007 through July 2007, with \$4.7 million occurring in July alone. In December 2006, penalties were approximately \$600K for all district offices combined. The staffing situation at the processing locations is inadequate to handle the volume of bill payments now processed in those offices.

As illustrated below in summary form, penalties reached unprecedented highs in April 2007 (\$3.5 million), May 2007 (\$4.4 million), June 2007 (\$4.0 million) and July 2007 (\$4.7 million). However, penalties as a percentage of paid losses decreased from 2.3% in June 2007 to 0.96% in July 2007 indicating that although a significant amount of penalties were incurred, an increased dollar amount of medical bills were paid during the month. This could demonstrate that the CPCs are catching up on some of the backlog that has plagued them for months. The graph below illustrates the change in total penalty payments for all CPCs from August 2005 through July 2007.



Findings and Recommendations

Based upon our review of the district offices, we identified the following findings and respective recommendations:

All District Offices

70. Lack of Formalized Claim Review

Finding

A lack of evidence existed in a portion of the claims testing regarding the proper review and approval of case reserves. A formal claim evaluation process has not been established.

Recommendation

Management should sign-off on the case reserve balances to indicate that the reviews, performed at least annually, and the case reserves were properly recorded. Establishment of a quality review function would enhance SCIF's ability to evaluate individual performance, identify training opportunities, and establish and monitor metrics across the organization. Additionally, procedures should be developed to ensure that all known medical costs are considered when case reserves are established and that actuaries are made aware of medical bill processing delays when determining reserves.

71. Claim Reserve Revisions

Finding

Case reserves estimated by the claim adjustor are often modified as medical bills are received instead of establishing case reserves based on the adjustor's best estimation of cost. A report is generated detailing claims in which medical bills paid exceed the reserve. These claims are the focus of routine reserve revisions. Due to the processing delay of medical bills received at the claims processing centers, there seems to be a consistent delay before case reserves are revised in response to the medical bill. This practice may result in understated case reserves for known medical costs.

Recommendation

Consistent methods should be followed to monitor timely completion of case reserve estimates.

72. Budget Cuts Not Aligned with Strategic Business Plans for Training and Development

Finding

It appears that implementation of the Electronic Claims File (ECF) software was not as effective as SCIF had planned, due, at least in part, to budget cuts. It is important that budget cuts align with strategic business plans developed for training and development. In addition, the ECF system does not retain an accurate historical listing of case reserve detail. Therefore, dates of case reserve changes could not be relied upon utilizing ECF. Internal Audit was aware of this system deficiency in a previous review; however, no action was taken to address this matter.

Recommendation

Additional training should be provided so that new or reassigned claims personnel are proficient with the ECF software and enter consistent and accurate claims data. Also, Internal Audit should conduct reviews of the district offices' implementation of this software on a rotational basis.

73. Notification of Quotes for Review Needed

Finding

PowerComp does not automatically advise supervisors of a quote to review; rather this is communicated outside of the system by email notification.

Recommendation

PowerComp should be automated to provide supervisors with notification of pending quotes requiring review.

Bay Area District Office

74. Inappropriate Authority to Approve Claims and Process Medical Bills

Finding

The district offices assisted with the processing of payments to help avoid late payment penalties; however, this practice raises concerns about the segregation of duties.

Recommendation

Medical bill payment capability should be limited to the claims processing centers.

San Diego District Office

75. Inadequate Staffing in Claims Area

Finding

Many aspects of the claims area seem to be out of compliance with SCIF protocol. Inadequate staffing is one factor that has led to the inability to migrate to ECF timely.

Recommendation

We recommend that SCIF assess the staffing level in the claims area and take appropriate action.

76. Need for Accurate Record Keeping Process

Finding

The scanning function at central processing locations occasionally scanned policy information into the wrong policy year. Isolated instances were noted where quotes included wrong brokerage commissions and other documentation deficiencies. Claims correspondence that is not routed to the proper e-mail station for follow-up may be lost. There is no system control to route this information to an appropriate e-mail suspense account. All applications/quote inquiries are received via one of three methods: fax, mail, or e-mail to a generic email address. There is no centralized system in place to track all of these methods of receipt.

Applications are submitted by either the employer or broker. All quotes are required to be issued within 10 business days of a completed/valid submission (application). However, there is no tracking system used to verify compliance with this 10 business day rule.

Recommendation

A protocol should be established to ensure a consistent record keeping process. Additionally, a suspense account for undelivered e-mail should be established and monitored to determine that no claim correspondence is lost.

77. Need for Consistent Processes for Policy Renewals

Finding

Certain policies that were renewed by the Customer Service Center did not follow the same renewal procedures as are followed by the district office (i.e., the inclusion of certain forms and notations of approval for merit ratings).

Recommendation

A consistent process for policy renewals should be established and followed.

78. Lack of Segregation of Duties for Posting of Credits and Custody of Cash

Finding

All payment plan payments pertaining to policies handled by the San Diego district office are received at the San Diego office as opposed to the normal procedure where premium payments are received at the home office. Once a payment is received in the local office, the office mails the checks to the home office for processing. The payment is not entered into any system locally, however, they are noted on tracking sheets of the credit analysts assigned to the account.

Recommendation

All payment plan payments should be sent to a customer service center to strengthen segregation of duties. This will ensure that payments are not being received by the same personnel who are responsible for issuing credit.

Orange County District Office

79. Incomplete Documentation in State Fund Online (SFO) System

Finding

There were several instances where new and/or renewal packages were not imaged. These documents provide the most detailed support for the data in the SCIF Online (SFO) system and because the districts are moving to a more paperless environment, oversight of the archiving of scanned documents is critical.

In addition, there were two instances where the broker commission shown in the SFO system did not agree to the home office calculation and actual payment of the broker commission. These instances raise doubt about the integrity of the data in the SFO system.

Recommendation

Within the existing underwriting procedure, a process should be established that ensures all underwriting documents are scanned and archived.

Additionally, a process should be implemented to verify that the payment of commission agrees to the actual calculation provided by home office.

80. Standardized Tracking and Monitoring Method Needed for Case Documents

Finding

As the means of tracking support documents are not consistent from adjuster to adjuster, the detection of errors or untimely decisions would be difficult for management or quality review teams to accomplish.

Recommendation

A process should be implemented that provides a consistent methodology in tracking and monitoring case documents to allow management or quality review teams to effectively detect errors or detect untimely decisions.

81. Stricter Controls Needed for Recurring Payments

Finding

There is a possibility for any adjuster to set up recurring payments for periods up to 52 weeks in the Wang Interchange Source Processor (WISP) system. The WISP system will authorize the first payment based on the adjusters authority limit code, but does not consider the total amount of all recurring payments.

An adjuster is able to establish a stream of recurring payments for an amount other than the calculated benefit amount without detection. The control to identify these types of errors is performance of a balancing process every two to four weeks; however, the adjuster performs the balancing on their own accounts and would be responsible for identifying their error.

Recommendation

The reconciliation between the recurring payments schedule and the adjuster's accounts should be reviewed by the adjuster's supervisor to guarantee that there are no inaccurate payments. The WISP system should consider the cumulative total of all recurring payments in accordance with the adjustors authority limits.

Bakersfield District Office

82. Review of District Office Procedures Needed to Conform With Established Protocol

Finding

The Bakersfield District Office establishes and maintains its own unique claims processing procedures without review by the Claims Rehabilitation Program Manager.

Recommendation

The Claims Rehabilitation Manager should independently evaluate the district office claims processing procedures to ensure they are consistent with the SCIF Home Office claims manuals and guidelines.

Based upon our review of the claims processing centers, we identified the following findings and respective recommendations:

All Claims Processing Centers

83. Late Payment Penalties Increase

Finding

Since the transition of bill payments to claims processing centers, medical and indemnity bill penalties paid for all district offices have increased significantly to \$19.5 million in penalties from January 2007 through July 2007, with \$4.7 million occurring in July alone. Budget cuts that were made to these centers did not follow the recommendation of the SCIF Board Chair or the Vice President who assumed management of these facilities.

Recommendation

SCIF should ensure that the problems at the claims processing centers resulting in significant late payment penalties are addressed. In August, SCIF hired a consultant to assist with this matter and hired temporary staff to address the processing backlog.

84. Need for Proper Establishment of Reserves for Known Claims

Finding

A significant portion of the random sample of claims payments reviewed appeared to have insufficient case reserves. In many instances, case reserves were not increased until the large bills were paid, which was subsequent to year end 2006, yet the bills were received by SCIF prior to December 31, 2006.

Recommendation

A process should be established to ensure all known medical payments, at a minimum, are considered when case reserves are established.

85. Identify and Prioritize High-Dollar Bills

Finding

Claims Processing Center Managers were not aware of a way to identify all high-dollar bills to move them up in the bill review queue.

Recommendation

An aging report for management should be developed to identify all old and high dollar-value unpaid and un-reviewed bills so they can be processed in a timely manner. Subsequent to testing, SCIF added a document type, such as hospital, doctor, etc., to the index of scanned medical bills. This allows SCIF the ability to sort by document type and potentially identify high dollar bills. The high dollar medical bills can then be manually assigned to a bill reviewer for processing.

Additionally, a report currently exists to identify unpaid bills under review of over \$5,000 and 45 days or more from receipt ("BDM Management Report – Unpaid Bills over \$5,000, 45 or more from receipt"). At a minimum, management should leverage this query to age and monitor unpaid bills currently under review that are nearing the 45 day mark.

Fairfield Claims Processing Center

86. Call Center Training Needed

Finding

The Fairfield Claims Processing Center does not have its own call center. They have no trained call center staff and no system to handle the incoming calls questioning the bills that are handled in Automated Bill Review (ABR).

Recommendation

Appropriate district office staff and the manager should be provided training to handle ABR related calls.

87. Limited Understanding of the Functions of the CPC

Finding

Certain Claims Managers have very limited knowledge of the claims processing functions.

Recommendation

The CPC Claims Managers should receive additional training on the functions of the Claims Processing Center. Certain CPC Claims Managers should be paired with a mentor in another CPC location and be encouraged to ask questions and participate in open discussions with this mentor.

Fresno Claims Processing Center

88. Quality Assurance Reviews Should be Re-established

Finding

Quality assurance reviews by the ABR supervisors were suspended in early April 2007 in an effort to reduce the backlog of unpaid medical bills.

Recommendation

The reviews performed by the ABR supervisors should be reinstated in order to ensure issues are identified on a timely basis.

89. Automated Control over the E-fax System

Finding

During some unknown period of time, the e-fax system that receives faxes from providers and enters them into ECF experienced some problems. In March 2007, a large quantity of bills that had not been previously received was transferred into ECF. Some had been paid with a subsequent or duplicate bill while others had not. The CPC had to review all of the invoices and determine the payment status of each bill.

Recommendation

The e-fax system problem needs to be resolved in order to avoid a similar large number of bills being recorded into the ECF system and to make certain duplicate payments are not made. Management should be provided with the status of the resolution and review of any duplicate payments.

Burbank Claims Processing Center

90. Ensure Access Controls to Archive Room is Restricted

Finding

The archive room was not locked and entry to the room was not monitored. Consequently, unauthorized access to insured's medical information and documents could occur, resulting in potential violation of HIPPA privacy rules.

Recommendation

Access to the archive room should be restricted to authorized employees only.

Summary

Backlog of Medical Bill Payments

Due to the significance and materiality of the medical bill payment penalties that occurred during 2007, SCIF should monitor the penalty reports for trends in penalty payments and ensure that the backlog of bills is decreasing and improving. As a method of dealing with the backlog of bills at the CPCs, SCIF hired a temporary staff of 60 in mid-August to assist with the backlog. Additionally, an external consultant was retained to review the operations at the claims processing centers.

Appropriate Establishment of Case Reserves

As adequate case reserving appeared to be a significant issue during site visits at the district offices and claims processing centers, SCIF should select samples from various district offices to obtain documentation and methodology for establishment of case reserves, as well as to identify whether improvements have been made with regards to making timely changes to case reserves as necessary.

Implementation of Option #3 Recommended by District Reorganization Oversight Committee

The District Reorganization Oversight Committee developed three different options, which assessed various aspects to address the issue of consolidating systems data in the merged offices. These options were presented to the Project Review Board in May 2007. The option chosen was the most costly and time consuming option; however, the option that would yield the greatest benefits. The effective date of the implementation will be either July 1, 2008, with the mid-year 2008 budget, or January 1, 2009, with the 2009 budget. All active and canceled policies in the system as of January 1, 2008 would retain their data, resulting in no claims or broker history being lost.

Once the full district office merger data consolidation has been implemented and presumed to be operating effectively, SCIF should test the system data integration to verify successful implementation.

Business Services

Background

Business Services has operations in the home office as well as in the Fairfield, Pleasanton and Chatsworth District Offices. Business Services is comprised of four units, which consist of operations, purchasing/transportation/supply, telecommunications and business applications. Business Services is also responsible for the contracting of and payment to IT vendors. The department is overseen by the Business Services Program Manager.

The Business Applications Unit was transferred from the Business Services Department to the Fiscal Department on the last day of testing, which was September 11, 2007. We understand that management in the Fiscal Department is conducting its own independent review and will implement enhanced control procedures once the integration of the unit is complete.

Operations Unit: The Operations unit is located primarily in Fairfield with some personnel housed in Chatsworth and Pleasanton. The unit is responsible for handling the mail for SCIF programs, which includes the processing of outgoing mail in Fairfield and Pleasanton. In addition, the unit is responsible

for warehouse management, the management of pool vehicles and the conversion of old records onto microfilm in Chatsworth and Fairfield.

Purchasing/Transportation/Supply Unit: SCIF does not follow the purchasing guidelines that are established by the State of California for state agencies, but rather follows its own internally established guidelines. SCIF stated that following the state agencies' guidelines would give non-government controlled insurance companies that SCIF competes with an operational advantage. The unit is also responsible for the overall management of the 2,000 fleet vehicles.

Telecommunications Unit: The Telecommunications unit at the home office controls the telecommunication systems at SCIF. In addition, this unit oversees the purchasing of all mobile telephone devices and all personal digital assistant (PDA) devices.

Business Applications Unit (i.e., Accounts Payable Unit): The Business Applications unit is responsible for accounts payable functions including vendor payments and employee reimbursements. As of September 11, 2007 this unit was transferred to the Fiscal and Investment Services Department.

IT Vendors: Business Services plays a role in the qualification of IT vendors. Currently, there are approximately 200 outside IT consultants. IT consultants are contracted to support normal operations and/or assist in the implementation of capital projects or the development and implementation of internally created software. Approximately \$321 million has been paid to IT vendors since 2004.

The IT Department is working to minimize the reliance on outside consultants by reducing the number of consultants to a range of 70 to 90 by 2009. SCIF indicated that no new consultants have been added over the past eight months in the IT Department and only existing consultants' contracts have been extended or renewed. Additional transformation is occurring as the IT Department plans to move its operations over to the new Vacaville Data Center sometime in 2008.

Specialty Invoices: The internal investigators identified some unusual or abnormal advertising and marketing invoices through vendor interviews and review of SCIF's e-mail system. These transactions occurred during 2005 and 2006 and circumvented the normal budget and procurement process. The abnormal invoices did not represent advertising or marketing services typically provided by these vendors.

Based upon information obtained during vendor interviews, it appears SCIF began the practice of obtaining goods and services from third parties through certain vendors prior to 2001. The arrangement between these vendors and certain SCIF executives was executed by vendors pre-billing SCIF for a specific amount of money. SCIF would then use these funds to obtain goods and services from third parties as directed by the SCIF executives.

Findings and Recommendations

Based upon our review of the business services area, we identified the following findings and respective recommendations:

91. Internal Audit of Fleet Management Needed

Finding

There are more than 2,000 fleet vehicles for a total of 8,000 employees. In spite of the significant cost of acquisition and maintenance of this vehicle fleet, SCIF has not performed an audit of fleet

management since 2003. The 2008 approved internal audit plan does not include a review of fleet management.

Recommendation

An internal audit of the fleet car pool should be performed as fleet management is an area where a large amount of funds are expended. An analysis of the need for fleet vehicles should be considered to determine whether all of the vehicles owned or leased by SCIF are necessary. On a periodic basis, the fleet manager should also perform an audit of the SCIF Monthly Travel Logs for compliance with SCIF policy.

92. Reasonableness Tests to Compare Miles Versus Expenses Not Performed

Finding

Each pool vehicle has an assigned gasoline card. A reasonableness test of miles driven to fuel charges is not performed by management.

Recommendation

Reasonableness tests of gasoline expense on a random sample of fleet vehicles should be performed by Business Services on a periodic basis to ensure cards are not used for unauthorized purchases.

93. Vehicle Mileage Audit Not Completed Periodically

Finding

Procedures have not been established to perform audits/reviews comparing fleet vehicle mileage to that reported on the SCIF Monthly Travel Log. Instances of inaccurate odometer readings were noted in our review of the travel log. Additionally, there is no tracking mechanism to verify that maintenance is being performed every 5,000 miles as required by SCIF policy and no individual is specifically held accountable for the pool vehicles' maintenance. Instances were noted in which employees would not travel off-site unless they receive approval to take their own vehicle due to the condition of the pool vehicle assigned.

Recommendation

On a periodic basis, the fleet manager should perform an audit of the SCIF Monthly Travel Logs for compliance with SCIF policy. Testing should include verification of the recorded mileage and any miles not related to SCIF business should be identified. In addition, substantiation of required maintenance should be performed.

94. Some Inequalities Exist Among Employee Benefits Regarding Fleet Vehicles

Finding

Supervisors at a level II category in district offices qualify for a SCIF vehicle and gas card benefit, but that same category of supervisors in the Customer Service Center (CSC) environment are not offered the same benefit. CSC job descriptions have been rewritten to increase time spent in the field in order to obtain cars; however, the time spent in the field is not accurate. We also noted that there are no special controls in place to review job description changes for fleet car status qualification.

Recommendation

For all employees with assigned vehicles, an audit of the time spent in the field versus time spent at their job site should be performed. For all employees not meeting the 50% requirement, the assignment of a SCIF owned vehicle should be discontinued. Consideration should also be given to allow employees the option of using their own vehicles for the occasional off-site travel requirements.

95. Large Backlog of Claims Files Not Filmed

Finding

Currently, there is a backlog of several years for the filming of closed paper claims files. These files are being microfilmed by two units with a total of 20 employees.

Recommendation

Given the magnitude of backlog (over 100,000 files) and the newer scanning and indexing processes available, consideration should be given to scanning/indexing these old claim files in lieu of microfilming.

96. Significant Contracts Signed by Inappropriate Personnel

Finding

The December 2000 SCIF approved policy for purchasing standards indicates the Business Services Manager was authorized to act as the sole agent for all purchases. During the review of contracts with IT vendors, we noted that most contracts were signed by a Business Services Representative not a Business Services Manager. Additionally, one contract was signed by the Business Applications Manager, who was also responsible for accounts payable function and another contract was signed by a Data Processing Manager II, in the IT Department.

Recommendation

To maintain the proper level of internal controls, a manager who is also responsible for the accounts payable function should not perform the purchasing function, even on a limited basis. Also, SCIF's policy states that no other department should be permitted to agree to any agreement or contract, for other than real property.

97. Contracts Entered into with Zero Cost

Finding

Prior to June 2007, contracts with IT vendors, for labor only, did not have a value based on the estimated hours and the hourly rate negotiated in the contract and were given a \$0 cost value on the Statement of Work. However, at the end of the contract terms these contracts could have paid amounts in excess of \$1 million.

Recommendation

SCIF stated that beginning in June 2007, the zero cost contract practice was discontinued and all contracts are now given a dollar value based on estimated hours and the contracted hourly rates. However, our testing samples did not reflect the new procedures implemented in June so we cannot verify this change.

Management should continue the practice of requiring a valid estimated cost be included on all Statements of Work and in all contracts. By doing so, the contracts will be signed and approved by an individual with the appropriate authority levels.

98. Accounts Payable Supervisor has Inappropriate Access within Oracle

Finding

The Accounts Payable Manager, who is responsible for all bill payments at SCIF through the Oracle system, has the highest level of authority in the system and has been identified as an Oracle "super user". An Oracle "super-user" is someone who is able to make any changes, additions or deletions to Oracle. Additionally, two supervisors reporting to the Accounts Payable Manager also have high levels of authority in the system similar to the Accounts Payable Manager. Changes are logged within the Oracle system. However, the reports detailing changes are not reviewed.

Recommendation

Authority levels for all Oracle users should be reviewed to determine whether the permissions given are appropriate. Please see IT Findings for further details on user permission recommendations.

99. Improperly Prepared Reconciliations of Funds Received

Finding

Two departments receiving funds for the PACE program incorrectly completed the reconciliation subsequent to the event. After we identified the error, a new reconciliation was provided that properly accounted for the PACE program expenditures and the reimbursement to SCIF.

Recommendation

All reconciliations and reimbursements for the PACE program should be thoroughly reviewed for accuracy before processing payments to SCIF employees.

100. Invoices Paid With No Purchase Order or Contract

Finding

In the sample of 30 payments charged to the Marketing Department, a total of nine payments were made without a purchase order or signed contract. Five of these payments related to vendors that are listed on the Master 594 form; however, a signed contract with these vendors still would be appropriate.

Recommendation

All payments should be evidenced by an approved purchase order or a fully executed contract.

101. Need for Consistent Invoice Processing Forms

Finding

In the sample of 30 payments charged to the Marketing Department cost center, two payments were submitted for payment with an Invoice Substitution form rather than an original vendor invoice. However, the two vendors were not included on the Master 594 listing as vendors not obligated to provide SCIF with invoices prior to payment.

Recommendation

Internal controls should be designed and implemented to ensure that expenditures are properly supported by an original invoice and approved prior to the release of funds. SCIF should consider additional testing in this area.

102. Employee Reimbursements Not Processed in Compliance with SCIF Policy

Finding

In the sample of 30 employee payments, three invoices from two different executives were submitted as 'rush' transactions and were given priority processing. None of these reimbursements were subject to the audit or approval process. Currently, there is no policy regarding the timely reporting of expense reports. Expense reimbursements can be submitted at any time with no restrictions applied. Per discussion with the Accounts Payable Manager, expense reimbursements designated as 'rush' are not common. Situations that would warrant such treatment include expenses that created a financial burden for the employee or if the employee was owed a significant amount of money.

Recommendation

A formal policy covering employee expense reimbursements should be established and followed at all times. These transactions should also be subjected to the audit and approval process in all instances.

103. Record Retention Policy Lacking

Finding

The Records Retention policy states that it is the responsibility of Business Services Managers to “develop and maintain record retention schedules for SCIF’s Programs” as well as “store and preserve records in an efficient, effective and secure manner.” Each business area retains its own record retention schedule, and the schedules are not retained centrally by the Business Services Department per the SCIF policy. The policy also fails to address the length of time records should be stored, the off-site storage facilities utilized by SCIF, procedures for sending items offsite, and the tracking of destruction dates.

Recommendation

The Business Services Department should make certain that retention schedules are developed and maintained for each business area, as well as maintain a central repository with all SCIF record retention schedules. The Records and Information Management policy should be updated to include the retention schedules for all business areas, as well as the length of time records should be stored, procedures for sending records offsite, off-site storage facilities utilized by SCIF, procedures for sending items offsite, and the tracking of destruction dates.

104. IT Vendor Contract Guidelines Vague

Finding

IT vendor contract guidelines are general in nature and do not address key control procedures, nor do they outline IT, Business Services, HR, or the Legal Departments’ roles in the vendor contract process.

Recommendation

IT vendor contract guidelines should be updated to provide specific policies and procedures for the following areas: 1) review and approval of IT vendor contract service, 2) preparation and approval of IT vendor service requisitions, 3) solicitation and evaluation of quotations such as price, vendor reliability and vendor quality, 4) review and approval of contracts by managers in the IT and Legal Department, 5) preparation and approval of purchase orders, 6) required procedures for a vendor background check, and 7) accounting for IT vendor services such as capitalization and expenditures. Additionally, retention of contracts should be centralized at SCIF to ensure that original contracts, amendments and any other pertinent information are available. SCIF is working with outside counsel to enhance the IT vendor contract process.

105. Methods for IT Contracting Should Be Realigned

Finding

Contracts for IT consultants used for operational purposes have been extended years beyond the original contract term. The consultants have been used to augment the existing IT operational staff on a long-term basis, and not necessarily to fill temporary needs. The use of IT consultants to fill long-term operational needs circumvents the HR hiring process and may not be cost beneficial. Additionally, this practice distorts the true IT departmental staffing needs in the budgetary process, and may increase security issues.

IT consultants that perform project development work are contracted over six month periods, and are not contracted by project. Using the IT consultants in this method circumvents both the HR hiring process and the vendor bid and selection process. By not requesting project bids, SCIF may not be receiving the best rates possible.

Recommendation

The method in which IT consultants are employed should follow SCIF prescribed policies and procedures. IT consultants used for operational purposes should be utilized for short-term needs only. For long term needs, IT needs to work with the HR Department to develop an annual budget for utilization requirements. IT consultants used for project development purposes should be contracted by project through the use of a fixed fee bidding process that requires key objectives and deliverables be met by the vendor.

106. IT Vendor Guidelines Should Address the Legal Department's Review

Finding

The purchasing agent decides whether the contract modification needs legal review and there is no guideline prepared by the Legal Department defining what requires legal review. Legal review is required only if outside vendor contracts are used or if purchasing agents make modifications to the standard model contract that they believe warrants legal review.

Recommendation

The SCIF Legal Department should establish written guidelines outlining the process for legal review of IT vendor contracts. These guidelines should include a definition of what modifications require legal oversight and define the criteria to be considered by the purchasing agents. Additionally, supervisory control should be established over the purchasing agents. This review should be conducted by a supervising Program Manager.

107. Lack of Adequate Vendor Background Check

Finding

The SCIF IT contract states that vendors are responsible for performing background checks on their employees. Background checks on IT vendors are not adequately performed to ensure legitimacy of the vendor. We performed background research on certain SCIF vendors, which revealed that one vendor, while working as an insurance lobbyist, was convicted of a felony in 1993. In addition, we have not received copies of the signed contract, amendments or requisitions for that particular vendor. As a result, we were not able to conclude on the legitimacy of the vendor and the employee who initiated the request.

Recommendation

SCIF should refine background checks for vendors and implement controls in Business Services to ensure compliance with all contract provisions.

108. IT Vendor Contract Documentation Not Available for Review

Finding

Complete information was received on only eight of the 20 IT vendors selected for review.

Recommendation

Retention of contracts should be centralized at SCIF to ensure that original contracts, amendments and any other pertinent information are available for review.

As a result of the Internal Audit IT Consultant Contract Review recommendation, dated November 8, 2006, Business Services now retains all original contracts and is the custodian of such contracts. However, contract information prior to November 2006 may not have been retained by Business Services. As a follow up, we provided the IT Department with a list of the missing vendor information to determine whether the IT Department retained any of the missing documentation. We have received documentation from the IT Department subsequent to September 11, 2007 and have not yet reviewed the completeness of the information.

109. Vendor Payment History Did Not Conform to Contract

Finding

Payments made to certain IT vendors were not in compliance with contract terms. In one instance, payments made to a vendor and its affiliates totaled approximately \$100 million from 1996 to 2006. Even though the term of the contract expired in 1997 the vendor continued to provide services and SCIF continued to make payments through 2006. No additional amendments or contractual agreements were received to support the vendor payment history. In September 2007 SCIF filed suit related to these vendor contracts

Recommendation

If payments deviate from contract terms, SCIF should keep a record of the reasons for payment inconsistencies in the files. Additionally, all contract revisions should be on file and kept with the master vendor contract. These contracts should be filed with the Legal Department.

110. Circumvention of SCIF Procurement/Budget Process

Finding

Internal investigators, through interviews of certain vendors and review of SCIF's email system, identified that SCIF engaged in inappropriate business practices that permitted unused encumbrances to be transferred to other budget accounts, allowing additional expenditures to be made in which there was no approved budget. This enabled funds to be used in subsequent budget years without going through the proper budget process. This practice also allowed SCIF to misclassify actual goods or services purchased. For example, one vendor that specializes in advertising and marketing billed SCIF for services not yet performed. The arrangement between the vendor and former SCIF executives was that the vendor would pre-bill SCIF for a specific amount and then use these funds to obtain goods and services from third parties as directed by former SCIF executives. The funds that SCIF paid to this vendor were used for items such as sponsorships, donations, golf tournaments and gifts. The CDI has referred these transactions to the joint task force.

The Board stated it was not made aware of this practice by former SCIF executives. A sample of invoices and follow-up interviews with SCIF executives revealed that this encumbrance practice also occurred under previous SCIF administrations.

Recommendation

All employees should receive ethics training including information regarding how to report unethical practices. The practice of using encumbrances has been part of the corporate culture at SCIF for some time. Employees require proper training on accruals verses encumbrances in

addition to training on proper budget techniques. The Board of Directors and SCIF executives should set the proper tone regarding corporate ethics and take the necessary steps to make certain the organization is in compliance with its ethic policies. Additionally, consideration should be given to requiring retroactive conflict of interest statements or disclosures for all procurement personnel and vendors.

Summary

The IT vendor contracts are vague and should require background checks and review by the Legal department. SCIF management communicated that the IT vendor contract process at SCIF is undergoing a review and that existing controls are in the process of being revised by management and outside legal counsel. An internal audit of the fleet vehicles should be conducted.